FEDERAL INCOME
ESTATE AND GIFT TAXATION

By

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To

WESLEY A. STURGES

PREFACE

Part I of this book is identical with my *Federal Income Taxation,* published in the fall of 1954; the preface which follows is reprinted from that volume and sets out my educational aims. I regret that it was not possible, on this printing, to open the printer's forms to correct typographical and other errors (in part, at least, the result of going to press only a few months after the Internal Revenue Code of 1954 was enacted) but the Errata and Addenda list on page xxvii will serve both to correct the more egregious errors and to note a number of recent developments.

Part II is a revision of my *Estate and Gift Taxation,* published in 1951. I have reprinted portions of my preface to that volume, since my approach to the subject is unchanged, despite many changes of detail.

I am very grateful to the authors and publishers who have consented to my use of extracts from their copyrighted works.

BORIS I. BITTKER

PREFACE TO PART I

This casebook was planned for a federal income tax course, preferably in the second year and after the student has had some work in corporations, trusts, and partnerships, of three or four semester hours. In that time, I believe that the bulk of the material can be adequately covered, at least if some portions are assigned for collateral reading without class discussion, though some sections (*e.g.*, corporate liquidations and reorganizations, non-family partnership problems, and accounting) might be reserved for more intensive study in an advanced course or seminar. If less time is to be devoted to federal income taxation, more drastic surgery would be called for, and I would be uncertain of the outcome. No doubt, a good deal of useful information can be passed along in a two-hour course or the equivalent, or even in less time, but it would certainly be an unusual student who would gain, so rapidly, a proper appreciation of the pervasive effect of income tax on the rest of our law.

I do not mean to suggest that my intended audience is the prospective tax "expert." Quite the contrary. I have tried to address myself to the student who has no premature vocational interest in taxation, because federal income taxation today has the same credentials for a place in the law school curriculum as sales or trade regulation or trusts: it is an essential part of the well-educated lawyer's professional background, whether he ultimately makes vocational use of it or not.

I have tried to avoid burying the student in minutiae (with which the Internal Revenue Code is always overstocked), and this book is not a reference work, but the subjects covered are dealt with in some detail, because a "survey" would convey nothing of the spirit of income tax law. I have had to omit many subjects that would reward study, in order to concentrate on those fundamental problems (*e.g.*, income-splitting, capital gains and losses, the business expense as contrasted with capital outlays and personal expenses, the characteristics of income, the concept of annual accounting, *etc.*) that every student should grapple with.

With a "comprehensive revision" [1] of the Internal Revenue Code before us, the instructor may be tempted to close the books and study only the new statute. But pre-1954 law continues to be of great importance under the new Code. For while there is much in the law of federal income taxation that is "evanescent," [2] there is also much that is, if not permanent, at least tenacious. It is noteworthy that even in the "comprehensive revision" of 1954, Congress drew back from proposals to alter the fundamental nature of the law at important points.[3]

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1 S. Rept. No. 1662, 83d Cong., 2d Sess., p. 1 (1954).

2 Coughlin v. Commissioner, *infra*, p. 232.

3 In the field of corporate distributions and adjustments, for example, the House version of the 1954 Code made drastic changes that the Senate Finance Committee successfully opposed: "The House bill in this area is, in substance, an entirely new statute, using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has

Many provisions of the 1939 Code were re-enacted *in haec verba* or with only very minor changes. In some circumstances, the old law continues to govern in general, with restricted modifications for some taxpayers — for example, the expenses of child care are still non-deductible as a rule, though a limited class of taxpayers may deduct them to a degree. In other areas, the taxpayer will be governed by the pre-1954 law unless he elects to come under an optional provision in the 1954 Code, as in the case of prepaid income and reserves for future expenses. In some areas (*e.g.*, much of the partnership and short-term trust material), the new Code codifies a good deal of case law and administrative regulations. Other areas have been drastically altered, but we almost never start with a clean slate. Even the hotly-debated credit for dividends received by individuals merely alters, without overturning, familiar comparisons between the corporation and the partnership or individual proprietership as alternative means of carrying on the closely-held or one-man enterprise. Much old law will continue to be relevant in litigated cases for many years, and some will affect future transactions because, for example, it governs the basis of property acquired before 1954 or the calculation of earnings and profits. At still other points, old cases, though overruled by the new Code, are excellent springboards for class discussion; and others, like *Commissioner* v. *Court Holding Co.*[4] and *Bazley* v. *Commissioner*,[5] generated principles that will govern in foreign territory even though largely displaced in the area of their birth by the new statute. In my opinion, the study of pre-1954 statutes, cases, and regulations in conjunction with the 1954 Code is not just a temporary expedient. It is, rather, essential to an understanding of the new statute and, moreover, it offers an unusual pedagogical opportunity to inspire the student to examine the new statute, as statutes should be examined, relentlessly.

In editing the cases that are reprinted, I have omitted footnotes freely, renumbering those that were left, and, in general, when old revenue acts are cited by the court, I have substituted a reference to the corresponding section of the "old" Internal Revenue Code, as it stood just before it was supplanted by the 1954 Code. I have similarly substituted the appropriate sections of Regulations 118 (as of the summer of 1954) in place of citations of earlier regulations. While I have not always indicated that a citation has been modernized, I have made changes, of course, only if the statute or regulation was not significantly amended in the interim. At the beginning of most sections, I have commented briefly on the relation between the 1954 Code and earlier law, so that in reading the cases and other materials the student may weigh the importance of any changes in the statute.

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sought to revise it so as to preserve the terms and concepts of existing law wherever possible. . . . The House bill departs from existing law by introducing the new terms, 'participating stock' (corresponding in general to common stock) and 'nonparticipating stock' (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term 'security.' . . . Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms 'stock,' 'common stock,' 'securities,' *etc.*, and, as in the case under existing law, has not attempted to define them in the statute." S. Rept. p. 42.

[4] *Infra*, p. 507.

[5] *Infra*, p. 538.

PREFACE TO PART II

Until 1950, casebooks had always relegated estate and gift taxation to a few pages or chapters, reserving major emphasis for other areas of the tax field. The appearance within one year of two books devoted exclusively to estate and gift taxes may be evidence either of a mounting interest in the subject or of the unquenchable optimism of publishers. So far, at least, few have granted to estate and gift taxation any more attention than is reflected by the subordinate position it occupies in the older casebooks.

The subject has become of increasing importance to the practicing lawyer. But even those addicted to the theory that there is a corpus of law to which every law student must be exposed would probably not say that a curriculum is fatally defective because it slights estate and gift taxation. The subject's claim for attention rather rests, in the author's opinion, in its power to stimulate and challenge the student. The interplay of legislative, administrative, and judicial action; the attempt to steer a course true to the statute's purpose through the ever-changing and involuted channels cut by reluctant taxpayers; the search for a better tax program — these offer a limitless opportunity to the instructor. Perhaps this, the second casebook in the field, will encourage more schools to exploit this opportunity.

A word about the structure of this volume. The gift tax is mainly a backstop to the estate tax; without the one, the other could achieve neither its social function of checking the undue concentration of wealth nor its incidental fiscal function of raising revenue. Part I [now Chapter 10] gathers together a brief collection of gift tax materials to give a bird's-eye view of the main outlines of this tax; then the reader passes on, in the first chapter of Part II [now Chapters 11–14], to consider the competing claims of the estate and gift taxes in specific situations. There the impact of the estate tax on various property arrangements is examined and then compared with the gift tax's claim on the same arrangement. The remaining chapters deal with the exemptions and deductions; computation of the federal estate tax and the credits applicable to it; federal estate and gift tax procedure; and apportionment of the federal estate tax among those interested in the gross estate.

There will no doubt be objection by some to the amount of space devoted to the comic fluctuations in the reach of the statutory provision taxing transfers "intended to take effect in possession or enjoyment at or after" the transferor's death. The author thinks this is a rich store of material on the whole process of law making — legislative, judicial, and administrative. Others may wish to skimp here to concentrate on today's statute; though divorced from its history it is indeed a tangle of peculiar distinctions. So too with the rather extensive section on community property: without this background, the student in a common law

state will find the "marital deduction," which entered the statute in 1948, an even more bafflingly complicated provision than it is.

Although the material in this volume can be adapted for use in a course on estate planning, the structure has not been oriented in that direction. This reflects the author's conviction that an estate plan that heavily stresses tax advantages, without giving at least as much attention to the law and practice of fiduciary administration, insurance, wills, and other relevant fields, is an inexcusable disservice to the client. And, despite a few notable exceptions, much of the writing on estate planning betrays a willingness to sacrifice everything else to a dramatic showing of tax savings, though to be sure there is usually a pious warning that an estate plan cannot be valued solely by the number of dollars that is diverted from the Treasury to the heirs. The exaltation of this kind of estate planning ought not to be fostered by law schools. Perhaps in time the estate planners among us will publish their own balanced vehicles of instruction. In the meantime, a casebook on taxation aimed primarily at the courses in estate planning might too easily displace the less accessible materials in the other equally important fields, and thus contribute to the improper emphasis just described.

The author has another reason for not moving toward what at the moment may seem to be the frontier of the future. Estate and gift taxes are the instruments of an important social policy. The practicing attorney, unless he happens to be on a public payroll, can hardly help but regard these levies as burdens to be avoided, if it is legally possible to do so. But the student has the time and the independence to reflect on their appropriate status in our public policy. If he can do so later on, when the problems of clients press themselves on him, so much the better. In any event, he will be a better citizen, and probably a better lawyer as well, if he has looked at these taxes at least once in the role of a legislator who is formulating a tax program. He will hardly do this in a course where he is playing estate planner; in the more orthodox tax course, at least the conditions are more suitable for such deliberation.

CONDENSED TABLE OF CONTENTS

PART I — FEDERAL INCOME TAXATION

PART II — FEDERAL ESTATE AND GIFT TAXATION

TABLE OF CONTENTS

PART I — FEDERAL INCOME TAXATION

PART II — FEDERAL ESTATE AND GIFT TAXATION

CONVERSION TABLE

1939 Code Sec. No.	1954 Code Sec. No.
1	
2	7608(a)
3	
4	
11	1
12(a)	
12(b)(1), (2)	
12(b)(3)	1
12(c)	1
12(d)	2
12(e)	
12(f)	1
12(g)	
13(a)	
13(b)	11
13(c)-(f)	
14	
15(a), (b)	11
15(c)	1551
21	63
22(a)	61
22(b)(1)	101
22(b)(2)(A)	72
22(b)(2)(B)	72, 403
22(b)(2)(C)	72
22(b)(3)	102
22(b)(4)	103
22(b)(5)	104
22(b)(6)	107
22(b)(7)	894
22(b)(8)	115, 526, 892, 893, 911, 912, 933, 943
22(b)(9)	108
22(b)(10)	108
22(b)(11)	109
22(b)(12)	111
22(b)(13)	112
22(b)(14)	113
22(b)(15)	621
22(b)(16)	114
22(b)(17)	121
22(c)	471
22(d)(1)-(5)	472
22(d)(6)	1321, 6155(a)
22(e)	301(a)
22(f)	1001
22(g)	861, 862, 863, 864
22(h)	Chapter 1, Subchapter G, Part III
22(i)	
22(j)	76
22(k)	71
22(l)	691
22(m)	73, 6201(c)
22(n)	62
22(o)	75
23	161, 211
23(a)(1)(A)	162
23(a)(1)(B)	162
23(a)(1)(C)	263
23(a)(2)	212
23(b)	163, 265
23(c)(1)	164
23(c)(2)	
23(c)(3)	164
23(d)	164
23(e)	165
23(f)	165
23(g)	165
23(h)	165
23(i)	165
23(j)	1091
23(k)(1)	166, 593
23(k)(2)	165(g)(1), 166(e), 582
23(k)(3)	165(g)(2)
23(k)(4)	166
23(k)(5)	166
23(k)(6)	271, 166
23(l)	167
23(m)	611
23(n)	167
23(o)	170
23(p)	404
23(q)	170
23(r)	591
23(s)	172
23(t)	168, 169
23(u)	215
23(v)	171
23(w)	691
23(x)	213
23(y)	
23(z)	216
23(aa)(1)	141
23(aa)(2)	36
23(aa)(3)	144
23(aa)(4)	4, 142
23(aa)(5)	142
23(aa)(6)	143
23(aa)(7)	144
23(bb)	173
23(cc)	616
23(dd)	592
23(ee)	1202
23(ff)	615
24(a)	261
24(a)(1)	262
24(a)(2), (3)	263
24(a)(4)	264
24(a)(5)	265
24(a)(6)	264
24(a)(7)	266
24(b)	267
24(c)	267
24(d)	273
24(e)	1451
24(f)	268
25(a)	35
25(b)(1)	151
25(b)(2)	153
25(b)(3)	152
26	241
26(a)	242
26(b)(1)	243
26(b)(2)	244
26(b)(3)	245
26(b)	246
26(c)	545, 556
26(d)	535, 545, 601
26(e)	
26(f)	561, 562, 564
26(g)	565
26(h)	247
26(i)	922
27(a)	561
27(b)	535, 562
27(c)-(i)	562, 564
28	565
31	33
32	32
33	6401
34	
35	31
41	441, 446
42(a)	451
42(b)-(d)	454
43	461
44	453, 7101
45	482
46	442
47	443, 6011(a)
48	441, 7701
51	6001, 6011(a)
51(a)	6001, 6012(a), 6065(b)
51(b)	6013(a), 6012(b)(1), 6014(b)
51(c)	6012(b)
51(d)	
51(e)	6065(a)
51(f)	6014(a) and (b), 6151(a), (b), 6155(a)
51(g)	6012(b), 6013(b), 6653(a), 6659.
52	6012(a), (b), 6062
53	6072, 6081, 6091
54(a)-(b)	6001
54(c)-(e)	
54(f)	6033(a), 6065(b)
55	6103, 7213(a)
56(a)	6151(a)
56(b)	6152, 6601(c)(2)
56(c)	6161(a), 6162(a), 6165, 7101
56(d)-(f)	
56(g)	6313
56(h)	
56(i)	6151(b)
56(j)	
57	
58	6012(b), 6015, 6064, 6065, 6073(a), (c), 6081(a), 6091(b), 6103, 6161(a)
59(a)-(c)	6153
59(d)	6201(b), 6315 6601(g)

1939 Code Sec. No.	1954 Code Sec. No.
60	6015(g), 6073(b), (d), (e); 6091(b), 6153(b), (d), (e)
61	
62	7805
63	6108
64	7701
101	502
101(1)-(11), (13-19)	501
101(12)	521, 522
102(a)	531, 532
102(b, c)	533
102(d)	535
102(e)	541
102(f)	536
103	891
104(a)	581
104(b)	11
105	632
106	1347
107(a)	1301
107(b)	1302
107(c)	1304(a)
107(d)	1303
107(e)	1304(b)
108	21
109	921
110	594
111	1001
112(a)	1002
112(b)(1)	1031
112(b)(2)	1036
112(b)(3)	354, 355
112(b)(4)	361
112(b)(5)	351
112(b)(6)	332
112(b)(6)(D)	7101
112(b)(7)	333
112(b)(8)	1081
112(b)(9)	378
112(b)(10)	371
112(b)(11)	355
112(c)	351, 356, 371, 1031
112(d)	361, 371
112(e)	351, 356, 361, 371, 1031
112(f)	1033
112(g)	368
112(h)	368
112(i)	367
112(j)	
112(k)	357, 371
112(l)	371
112(m)	1071
112(n)	1034
113(a)	1012
113(a)(1)	1013
113(a)(2)	1015
113(a)(3)	1015
113(a)(4)	1015
113(a)(5)	1014
113(a)(6)	358, 1031
113(a)(7)	362
113(a)(8)	362
113(a)(9)	1033
113(a)(10)	1091
113(a)(11)	1051
113(a)(12)	1052
113(a)(13)	723, 732
113(a)(14)	1053
113(a)(15)	334
113(a)(16)	1052
113(a)(17)	1082
113(a)(18)	334
113(a)(19)	307
113(a)(20)	373
113(a)(21)	373
113(a)(22)	372
113(a)(23)	358
113(b)	1011
113(b)(1)	1016
113(b)(2)	1016
113(b)(3)	1017
113(b)(4)	1018
113(c)	1019
113(d)	1020
113(e)	1022
114(a)	167(f)
114(b)(1)	612
114(b)(2)	
114(b)(3)	613(b)(3)
114(b)(4)	613(b)(4)
115(a)	301, 316
115(b)	301, 316
115(c)	302, 312, 331, 342
115(d)	301
115(e)	301
115(f)	305
115(g)(1)	302
115(g)(2)	304
115(g)(3)	303
115(h)	312
115(i)	302, 346
115(j)	301
115(k)	
115(l)	312
115(m)	312
116(a)	911
116(b)	
116(c)	892
116(d)	115
116(e)	115
116(f)	943
116(g)	526
116(h)	893
116(i)	121(a)(17)
116(j)	912
116(k)	912
116(l)	933
117(a)	1221, 1222
117(b)	1202
117(c)	1201
117(d)	1211
117(e)(1)	1212
117(e)(2)	
117(f)	1232
117(g)(1)	1233
117(g)(2)	1234
117(g)(3)	1238
117(h)	1223
117(i)	582
117(j)	1231
117(k)	631
117(l)	1233
117(m)	341
117(n)	1236
117(o)	1239
117(p)	1240
118	1091
119(a), (b)	861
119(c), (d)	862
119(e)	861, 862, 863
119(f)	864
120	170
121	583
122	172
123	77
124	
124A	168
124B	169
125	171
126	691
127(a), (b)	
127(c)(1)	1331
127(c)(2)	1332
127(c)(3)	1333
127(c)(4)	1334
127(c)(5)	1335
127(d)	1336
127(e)	1337
127(f)	1337
128	1346
129	269
130	270
130A	421
131(a)	901
131(b)	904
131(c)	905, 6155(a), 7101
131(d)	905
131(e)	905
131(f)	902
131(g)	901(c)
131(h)	903
131(i)	905
141	1501, 1502, 6071, 6081(a), 6091(b)(2), 6503(a)(2)
142	6012(a), (b), 6065(a)
143(a)	1451
143(b)	1441
143(c)	1461, 6011(a), 6072(a), 6091(b), 6151(a)
143(d)	1462
143(e)	1463
143(f)	1464, 6414
143(g)	1461
143(h)	1443, 6151
144	1442, 6151(a)
145	7201, 7202, 7203, 7343
146	443, 6155(a), 6601(a) 6658, 6851, 7101
147	6041(b), (c); 6071, 6081(a), 6091(a)
148	6042, 6043, 6044, 6065(a), 6071, 6081(a), 6091(a)
149	6045, 6065(a), 6071, 6081(a), 6091(a)
150	6071, 6081(a), 6091(a), 7001(a), 7231
151	
153(a)	6033(b), 6071, 6081(a), 6091(a)
153(b)	6034, 6071, 6081(b), 6091(a)
153(c)	6104
153(d)	7201, 7203
154	692
161	641
162(a)	642(c)
162(b)	651, 652, 661, 662
162(c)	661
162(d)	643, 663
162(e)	642
162(f)	642
162(g)	681
163(a)(1)	642
163(a)(2)	642
163(b)	642
163(c)	642(a)(1)
164	652, 662
165(a)	401, 501(a)
165(b)	402
165(c)	402
165(d)	402
166	676
167	677
168	642
169(a)-(c)	584, 6065
169(d)(1)-(3)	584
169(d)(4)	584
169(e)	584
169(f)	6032, 6065(a)
169(g)	584
170	642, 584
171	682
172	642
181	701
182	702
183(a), (b)	702, 703
183(c)	702
183(d)	703(a)
184	702
186	702
187	6031, 6063, 6065(a)
188	706
189	702, 703
190	
191	704

1939 Code Sec. No.	1954 Code Sec. No.
271	6211, 6653(c)(1)
272(a)	6212(a), (b)(2); 6213(a)
272(b)	6155(a), 6215(a)
272(c)	6155(a), 6213(c)
272(d)	6213(d)
272(e)	6214(a)
272(f)	6212(c), 6213(b)(1)
272(g)	6214(b)
272(h)	6214(c)
272(i)	6152(c), 6601(c)(2)
272(j)	6161(b), 6165, 7101
272(k)	6212(b)
273(a)-(i), (k)	6155, 6861, 6863(a), (b), 7101
273(j)	6404(b)
274	6036, 6155(a), 6161(c), 6503(b), 6871, 6872, 6873
275	6501
276	6501(c), 6502(a)
277	6503(a)
291	6651(a), 6659
292	6155(a), 6601
293	6653(a), 6659
294	6601, 6651(c), 6654(a)
295	6601
296	6601
297	6601
298	6601
299	6658
311	6901
312	6903
313	
321	6403
322(a)(1)-(3)	6401, 6402
322(a)(4)	31
322(b)(1)	6511
322(b)(2)	6511
322(b)(3)	6511
322(b)(4)	6151(c), 6513(a), 6611(d)
322(b)(5)	6511(d)
322(b)(6)	6511(d)
322(c)	6512(a)
322(d)	6512(b)
322(e)	6151(c), 6513(b), 6611(d)
322(f)	
322(g)	6511(d)
400	3
401	4
402	4
403	36
404	4
421(a), (b)	501, 511
421(c), (d)	512
422(a)	512
422(b)	513
423	514
424	515
800	2001, 2101
801	
802	
810	2001(a), 2011(a), 2011(b)
811	2031(a)
811(a)	2033
811(b)	2034
811(c)	2035, 2036, 2037
811(d)(1)	2038(a)(1)
811(d)(2)	2038(a)(2)
811(d)(3)	2038(b)
811(d)(4)	
811(e)	2040
811(f)	2041
811(g)	2042
811(h)	2044
811(i)	2043(a)
811(j)	2032
811(k)	2031(b)
811(l)	2035
811(m)	
812	2051
812(a)	
812(b)	2043(b), 2053, 2054
812(c)	
812(d)	2055
812(e)	2056
813(a)(1)	
813(a)(2)	2012
813(b)	2011
813(c)	2014
820	6036, 6091(a)
821(a)	6018, 6065(a)
821(b)	6071, 6075(a), 6081(a)
821(c)	6091(b)
821(d)	6001
821(e)	
822(a)(1)	6151(a)
822(a)(2)	6161(a)(2), 6165, 6503(d), 7101
822(b)	2002
823	6314(b)
824	
825	2204
826(a)	7404
826(b)	2205
826(c)	2206
826(d)	2207
827(a)	6324(a)(1), 6325(a)(1)
827(b)	6324(a)(2)
827(c)	6324(a)(3)
828	
840	
841	
850	2202
851	
860	2101
861	2102, 2103, 2106
862	2104
863	2105
864(a)	6018, 6065(a)
864(b)	6071, 6075(a), 6081(a)
864(c)	6091(b)
865	
870	6211(a), 6653(c)(1)
871(a)	6212(a), 6213(a)
871(b)	6155(a), 6215(a)
871(c)	6155(a), 6213(c)
871(d)	6213(d)
871(e)	6214(a)
871(f)	6212(c), 6213(b)
871(g)	6214(c)
871(h)	6161(b)(2), 6165, 6503(d), 7101
871(i)	6653(b), 6659(a)
872(a)	6155(a), 6861(a)
872(b)	6861(b)
872(c)	6861(c)
872(d)	6861(d)
872(e)	6861(e)
872(f)	6863(a), (b)(2), 7101
872(g)	6155(a), 6863(b)(1)
872(h)	6863(a), (b)(2)
872(i)	6155(a), 6861(f)
872(j)	6861(g)
873	6404(b)
874(a)	6501(a)
874(b)(1)	6501(c)(1), 6501(c)(3)
874(b)(2)	6502(a)
874(b)(3)	2016, 6071, 6081, 6091, 6155
875	6503(a)(1)
876	
890	6601(a), 6601(b), 6601(f)(1)
891	6155(a), 6601(a), (d), (f)(1)
892	6601(a), 6601(c)(3)
893	6601(a), (c), (f)
894(a)	6651(a), 6653(a)
894(b)	7201, 7202, 7203, 7207, 7269, 7343
900(a)	6901(a)(b)
900(b)	6901(c)
900(c)	6901(f)
900(d)	6904, 7421(b)
900(e)	6901(h)
901(a)	6903(a)
901(b)	6903(a)
901(c)	6903(b)
901(d)	6212(b)
910	6511
911	6512(a)
912	6512(b)
913	
920	
921	
925	6601(a), (b), 6163(a)
926	6163(a), 7101
927	2015
930(a)	2203
930(b)	
930(c)	
930(d)	
931	
935	2001, 2052, 2101
936(a)	
936(b)	2012
936(c)	2014
937	6018(a), 7203
938	6103
939	2201
1000(a)	2501
1000(b)	2511(a)
1000(c)	2514
1000(d)	
1000(e)	
1000(f)	2513
1000(g)	
1001(a)	2502(a)
1001(b)	2502(c)
1001(c)	
1002	2512(b)
1003	2503
1004(a)(1)	2521
1004(a)(2)	2522
1004(a)(3)	2523
1004(b)	2522
1004(c)	2524
1005	2512(a)
1006(a)	6019(a), 6065(a)
1006(b)	6075(b), 6091(b)(1)
1007	6001
1008(a)	2502(d), 6151(a)
1008(b)	6161(a)(1)
1008(c)	
1008(d)	6313
1008(e)	6314(a)
1009	6324(b), 6325(a)(1)
1010	
1011	6211(a), 6653(c)(1)
1012(a)	6212(a), 6213(a)
1012(b)	6155(a), 6215(a)
1012(c)	6155(a), 6213(c)
1012(d)	6213(d)
1012(e)	6214(a)
1012(f)	6212(c), 6213(b)
1012(g)	6214(b)
1012(h)	6214(c)
1012(i)	6161(b)(1), 6165, 7101
1012(j)	6212(b)
1013(a)	6155(a), 6861(a)
1013(b)	6861(b)
1013(c)	6861(c)
1013(d)	6861(d)
1013(e)	6861(e)
1013(f)	6863(a), 6863(b)(2), 7101
1013(g)	6155(a), 6863(b)(1)
1013(h)	6863(a), (b)(2)
1013(i)	6155(a), 6861(f)
1013(j)	6861(g)
1014	6404(b)
1015(a)	6371
1015(b)	6155(a), 6161(c), 6503(b), 6873(a)
1016	6501, 6502(a)
1017	6503(a)(1)
1018	
1019	6653, 6659(b)
1020	6601(a), (f)(1)
1021	6155(a), 6601(a), (d), (f)(1)
1022	6601(a), (c)(3)

1939 Code Sec. No.	1954 Code Sec. No.
1023	6601(a), 6601(c)(1), 6601(f)(1)
1024(a)	7201, 7203
1024(b)	7201
1025(a)	6901(a), (b)
1025(b)	6901(c)
1025(c)	6901(e)
1025(d)	6901(f)
1025(e)	6904, 7421(b)
1025(f)	6901(h)
1025(g)	6901(g)
1026(a)	6903(a)
1026(b)	6903
1026(c)	6903(b)
1027(a)	6402(a)
1027(b)	6511(a), (b)
1027(c)	6512(a)
1027(d)	6512(b)
1028	
1029	7805(a)
1030(a)	2502(b)
1030(b)	2511(b)
1031	6103
1100	7441
1101	7442
1102(a)-(g)	7443(a)-(g)
1103(a)-(d)	7444(a)-(d)
1104	7445
1105	7446
1106	7447
1110	7451
1111	7453
1112	7454(a)
1113	7455
1114	7456(a)
1114(b)	7456(c)
1115(a)	7457(a)
1115(b)	7457(b)
1116	7458
1117(a)-(f)	7459(a)-(f)
1117(g)	6155(a), 6659, 6673
1117(h)	
1118	7460
1119	6902
1120	7461
1121	7462
1130	7471
1131	7472
1132	7473
1133	7474
1140	7481
1141	7482
1142	7483
1143	7484
1144	
1145	7101, 7485(a)
1146	7486
3600	7601(a)
3601(a)(1)	7606(a)
3601(a)(2)	7606(b)
3601(b)	7342
3601(c)	7212(a), (b)
3602	
3603	6001
3604(a)	6046(a), 6071, 6091(a)
3604(b)	6046(b), 6046(c), 6065(a)
3604(c)	7203, 7201
3611(a)(1)	6011(a), 6081(a), 6091(a), 6091(b)(1), 6091(b)(2)
3611(a)(2)	6020(a)
3611(b)	6071
3611(c)	6065(a), 6071, 6091(a), 6091(b)(1), 6091(b)(2)
3612(a)	6020(b)
3612(c)	6020(b)
3612(d)(1)	6651(a)
3612(d)(2)	6653(b)
3612(e)	
3612(f)	6201(a)(1)
3613	6021
3614	7602, 7605(a)
3615	7605(a)
3615(a)	7602
3615(b)	7602
3615(c)	7602
3615(d)	7603
3615(e)	7604(b)
3616(a)	7207
3616(b)	7210
3616(c)	
3617	
3630	6101
3631	7605(b)
3632(a)	7622(a)
3632(a)(1)	7602
3632(b)	7622(b)
3633	7402(b)
3633(a)	7604(a)
3633(b)	
3634	6081(a)
3640	6201(a)
3641	6203
3642	6204
3643	
3644	6202
3645	
3646	
3647	6201(a)
3650	7621
3651(a)(1)	6301
3651(a)(2)	
3651(b)	
3652	6302(a)
3653(a)	7421(a)
3653(b)	7421(b)
3654	
3655(a)	6303(a), 6659
3655(b)	6601(a), 6601(f)(1), 6659
3656(a)(1)	6311(a)
3656(a)(2)(A)	6311(b)(1)
3656(a)(2)(B)	6311(b)(2)
3656(b)(1)	6311(a)
3656(b)(2)	6311(b)(1)
3657	6312(a)
3658	6313
3659(a)	6314(a)
3659(b)	
3660	6331(a)
3660(a)	6155(a), 6862
3660(b)	6863(a), 7101
3661	7501
3662	
3663	
3670	6321
3671	6322
3672	7207
3672(a)	6323(a)
3672(b)	6323(d)
3673(a)	6325(a)(1)
3673(b)	6325(a)(2)
3674(a)	6325(b)(1)
3674(b)	6325(b)(2)
3675	6325(c)
3676	7102
3677	
3678	7403
3679(a)	7424(a)
3679(b)	
3679(c)	7424(b)
3679(d)	7424(c)
3680	
3690	6331(a), (b)
3691	6334
3692	6331(a), 6331(b), 6334(c)
3693	6335(e)(2)(E)
3693(a)	6335(a)
3693(b)	6335(b)
3693(c)	6335(d)
3693(d)	6335(e)(2)(F)
3694	6342(a)
3695(a)	6335(e)(1), 6335(e)(2)(A)
3695(b)	6335(e)(2), 7505(a)
3695(c)	7505(b)
3696	6337(a)
3697(a)	6339(a)(1)
3697(b)	6339(a)(2)
3697(c)	6339(a)(3)
3697(d)	6339(a)(4)
3698	
3700	6331(a), 6331(b)
3701	6335(e)(2)(E)
3701(a)	6335(a)
3701(b)	6335(b)
3701(c)	6335(d)
3701(d)	6335(e)(1), (2)(A), (B)
3701(e)	6335(e)(1)
3701(f)	6335(e)(2)(D), (F); 6335(e)(3)
3702(a)	6337(a)
3702(b)(1)	6337(b)(1)
3702(b)(2)	6337(b)(2)
3702(c)	6337(c)
3703(a)	6338(c)
3703(b)	6338(a)
3704(a)	6338(c)
3704(b)	6338(b)
3704(c)(1)	6339(b)(1)
3704(c)(2)	6339(b)(2)
3705	
3706(a)	6340(a)
3706(b)	6340(a)
3706(c)-(e)	
3706(f)	6340(b)
3707	
3710(a)	6332(a)
3710(b)	6332(b)
3710(c)	6332(c), 7343
3711	6333
3712	6335(c), 6342(b)
3713	
3714(a)	
3714(b)	6502(b)
3715	6331(c)
3716	6341
3717	
3720(a)(1)	7301(a)
3720(a)(2)	7301(b)
3720(a)(3)	7301(c)
3720(b)	7321
3720(c)	
3721	7322
3722	7324
3722(a)	7324(1)
3722(b)	7324(2)
3722(c)	7324(3)
3722(d)	7324(4)
3723(a)	7323(a)
3723(b)	7323(b)
3723(c)	7323(c)
3723(d)	
3724	7101, 7325
3725	6807
3726	7327
3727	
3740	7401
3742	
3743	
3745	
3746(a)	7405(a)
3746(b)	6532(b), 7405(b)
3746(c)	
3746(d)	6602
3747	7406
3748	6531
3760	7121
3761	7122
3762	7206(5)
3770(a)(1)	6402(a), 6404(a)
3770(a)(2)	6401(a)
3770(a)(3)	6407
3770(a)(4)	6402(a)
3770(a)(5)	6402(a), 6404(a)
3770(b)	7423
3770(b)(1)	7423(1)
3770(b)(2)	7423(2)

1939 Code Sec. No.	1954 Code Sec. No.
3770(c)	6401(c)
3771(a)	6611(a)
3771(b)(1)	6611(b)(1)
3771(b)(2)	6611(b)(2), 6611(e)
3771(c)	6611(c)
3771(d)	
3771(e)	6611(f)
3771(f), (g)	
3772(a)(1)	7422(a)
3772(a)(2)	6532(a)(1)
3772(a)(3)	6532(a)(4)
3772(b)	7422(b)
3772(c)	
3772(d)	7422(c)
3772(e)	7422(d)
3773	
3774	6514(a)
3774(b)	6532(a)(2)
3775	6514(b)
3777(a)	6405(a)
3777(b)	6405(b)
3777(c)	6405(c)
3778	
3779(a)	6091(a), 6164(a)
3779(b)	6065(a), 6071, 6081(a), 6164(b)
3779(c)	6164(c)
3779(d)	6164(d)
3779(e)	6164(e)
3779(f)	6164(f)
3779(g)	6164(g)
3779(h)	6155(a), 6164(h)
3779(i)	6601(a), 6601(e), 6601(f)(1)
3780(a)	6065(a), (b); 6071, 6091(a), 6411(a)
3780(b)	6411(b)
3780(c)	6213(b)(2)
3781	6164(i), 6411(c)
3790	6406, 6611(g)
3791(a)	6071, 6081(a), 6091(a), 6091(b)(1)(2) 7805(a)
3791(b)	7805(b)
3792	7623
3793	7206(3)
3793(a)(2)	7303(8)
3793(b)	7206(2), 7207
3793(b)(2)	7343
3794	6601(a)
3795(a)	7506(a)
3795(b)	7506(b)
3795(c)	7506(c)
3795(d)	7506(d)
3797(a)(1)-(11)	7701 (a)(1)(11)
3797(a)(12)	7701(a)(13)
3797(a)(13)	
3797(a)(14)-(20)	1465, 7701 (a)(14)-(20)
3797(b)	7701(b)
3797(c)	7701(c)
3798	7507
3799	77
3800	7402(a)
3801	1311-1314
3802	7511
3803	7852(a)
3804(a)	7508(a)
3804(b), (c)	
3804(d)	7508(b)
3804(e)	
3804(f)	7508(a)
3805	6072(e)
3806	1481
3808	
3809(a)	7206(1)
3809(b)	6061, 6064
3809(c)	6065(a)
3810	
3811	7651
3812	6521
3813	503
3814	504
3900	7802
3901(a)	6801(a), 7805(c)
3901(b)	7803(b)(2)
3905	
3906	
3910	
3911	
3915	
3916	
3920	7803(a)
3921	7803(a)
3930(a)	7801(b)
3930(b)	
3931	7801(b)
3932	7801(c)
3940	
3941	
3942	
3943	7803(c), 7101
3944	
3950	
3951	
3952	
3953	
3954	
3955	
3960	
3961	
3962	
3963	
3964	
3965	
3966	
3967	
3970	7808
3971(a)	7809(a)
3971(b)	7809(b)
3971(b)(1)	7809(b)(1)
3971(b)(2)	7809(b)(2)
3971(b)(3)	7809(b)(3)
3975	7803(d)
3976	7803(d)
3977	7803(d)
3978	7803(d)
3990	
3991	
3992	7101, 7402(d), 7803(c)
3993	
3994	
3995(c)	7402(d)
3996	
3997	
4000	7803(a)
4001	
4002	
4003	
4010	7101, 7803(c)
4011	
4012	
4013(a)	5241
4013(b)-(d)	
4014	
4015	
4016	
4017	
4018	
4019	
4020	
4021	
4022	
4030	
4031	
4032	
4033	
4040	7803(b)(1)
4041(a)	7803(a)
4041(b)	
4042	7402(c)
4043	
4044	
4045	
4046	
4047(a)(1)	7213(b)
4047(b)	7214(b)
4047(c), (d)	
4047(e)	7214(a)
4048	7344
5000	8001
5001	8002
5002	8003
5003	8004
5004	8005
5010	8021
5011	8022
5012	8023

ERRATA AND ADDENDA

PAGE

3 — Note 5: *For* Chapter 9, Sec. B, *read* p. 831.
20 — Note 33: *For* Chapter 3, Sec. B(5), *read* pp. 279–280.
23 — Note 35: *For* Chapter 9, Sec. B(2), *read* pp. 832–833.
83 — Note ¶2: One of the rulings referred to here was revoked by Rev. Rul. 55–138.
84 and 88 — *See General Amer. Investors Co.* v. *Comm.*, 348 U.S. 434, 75 S. Ct. 478 (1955).
88 — The *Glenshaw Glass Co.* and *Wm. Goldman Theatres* cases were reversed by the Supreme Court, 348 U.S. 426, 75 S. Ct. 473 (1955).
94 — Note: §1341 limits the tax due for the year the item is repaid, rather than granting a refund of the earlier year's tax. See *infra*, p. 744.
115 — Note ¶1: *See* Rev. Rul. 55–422, repayments to retired ministers and rabbis.
124 — Note ¶1: *Bates* v. *Glenn* was affirmed, 217 F.2d 535 (6th Cir. 1954); see also *Campeau* v. *Commissioner*, 24 T.C. No. 39 (1955). The S. Rept. on the 1954 Code implies (p. 179) that door prizes are now taxable.
124 — Note ¶3: A Guggenheim fellowship was held to be a "gift" in *Stone* v. *Commissioner*, 23 T.C. 254 (1954).
129 — At bottom: *Add* as footnote: With the *Hatch* case, see §691, *supra*, p. 114, note 1.
154 — ¶2, line 7: For §511(a)(2)(A), *read* §511(a)(2)(B).
154 — Note ¶4, lines 9 and 10: *Transpose* including *and* excluding.
154 — Note ¶4, line 16: *For* §1(a), *read* §1(c).
155 — Line 5: *For* p. 75, *read* p. 175.
158 — Line 16: *For* Chapter 3, Sec. C, *read* pp. 279–280.
163 — The Internal Revenue Service's views on a number of medical expense questions are set out in Rev. Rul. 55–261; see also *Ring* v. *Commissioner*, 23 T.C. No. 119 (1955) (trip to Lourdes); *Hollander* v. *Commissioner*, 219 F.2d 934 (3d Cir. 1955).
164 — Note ¶2, line 2: *For* Chapter 3, Sec. C, *read* pp. 279–280.
169 — Note ¶1: The Internal Revenue Service has ruled that no gain or loss is realized even if a pledge in dollars is satisfied by a transfer of appreciated or depreciated property. Rev. Rul. 55–410. The Service has also revoked I.T. 3910, which ruled that income was realized by a farmer who made a donation of agricultural products to a charitable organization. Rev. Rul. 55–138.
169 — Last line of Note: *For* Chapter 4, Sec. C(1), *read* p. 299.
174 — 3d line from bottom: The limiting date for §71(a)(3) is March 1, 1954.
175 — Note ¶2(c): *Holahan* v. *Commissioner* was affirmed, — F.2d — (2d Cir. 1955).
175 — Note ¶4, line 14: *Transpose* lessor *and* lessee.
188 — Note ¶1: *Still* v. *Commissioner* was affirmed, 218 F.2d 639 (2d Cir. 1955).
191 — Last line of Note: *For* Chapter 3, Sec. B(7), *read infra*, p. 255.
193 — Note ¶1: On the computation of "support," see *Blarek* v. *Commissioner*, 23 T.C. No. 129 (1955).
193 — Last line of Note: *For* Chapter 4, Sec. B, *read infra*, p. 285.
194 — Second line from bottom: *For* Chapter 6, Sec. A, *read infra*, pp. 456–457.
197 — Line 4: *For* Chapter 5, Sec. C, *read* pp. 402–405.
208 — Note ¶1: *Parsons* v. *United States*, 126 F. Supp. 552 (D.N.J. 1954), holds that depreciation on a rented house may be based on its value when converted, if that exceeds original cost.
222 — Note ¶5: On moving expenses, see also Rev. Ruls. 54–429 and 55–140.
255 — 3d line from bottom: *For* Section 2(k)(1), *read* Section 23(k)(1).
263 — Note ¶1: *Allen* v. *Edwards* was affirmed, 216 F.2d 794 (5th Cir. 1954).
276 — Note ¶2 *See* §263(b), 1954 Code.
279 — *Re* the *F.H.E. Oil Co.* cases, see §263(c), 1954 Code.
289 — Note ¶2: On the use of duress to get the wife to sign a joint return, see *Hickey* v. *Commissioner*, ¶55, 149 P-H Memo TC; *Aylesworth* v. *Commissioner*, 24 T.C. No. 18 (1955).
312 — First line: *For* will also be taxed, *read* will also not be taxed.
321 — Note ¶3: For the relation of the *Clifford* case and regulation to *Blair* v. *Commissioner*, *supra*, p. 300, see Rev. Rul. 55–38.

PAGES

359—Last line: *For* §163(a)(3), *read* §162(a)(3).
395—Note ¶3: *Bagley & Sewall Co.* v. *Commissioner* was affirmed, 221 F.2d 944 (2d Cir. 1955).
405—Note ¶2: *Grier* v. *United States* was affirmed *per curiam,* 218 F.2d 603 (2d Cir. 1955).
405—Last line: *For* Regs. 188, *read* Regs. 118.
408—Line 10 of opinion: So in original, but the words "[plus taxable income]" should be inserted after "gains" for accuracy.
416—Line 6: *For* Sections 421 and 423 [1939 Code], *read* Section 514 [1954 Code].
418—6th line from bottom: The Internal Revenue Service has announced that it will continue to apply Mim. 6490 except where §1235 of the 1954 Code is applicable. Rev. Rul. 55–58. See also *Block* v. *United States,* 200 F.2d 63 (2d Cir. 1952).
421—4th line from bottom: So in original, but 1939 should be 1937; see 43 B.T.A. at 782.
434—Note ¶1: See also *Commissioner* v. *Goff,* 212 F.2d 875 (3d Cir. 1954), cert. den. 348 U.S. 829; *Roscoe* v. *Commissioner,* 215 F.2d 478 (5th Cir. 1954).
435—Note ¶3, line 19: *For* pay, *read* receive.
442—Note ¶3: See *Sun Properties, Inc.* v. *United States,* 220 F.2d 171 (5th Cir. 1955).
469–70—Note ¶2: See Rev. Rul. 54-596, 54-2 C.B. 51.
474—Line 3 of last full paragraph: *For* §1033, *read* §1231.
474—Line 5 of last full paragraph: *For* Sec. 29.31(b), *read* Sec. 24.31(b).
479—Note ¶1: *Nat'l Bellas Hess, Inc.* v. *Commissioner* was affirmed, 220 F.2d 415 (8th Cir. 1955).
485—1st full paragraph: See *Gross* v. *Commissioner,* 23 T.C. No. 97 (1955).
490—See Rev. Rul. 55–15.
516—Note ¶1: See also *Nat'l Gasoline Corp.* v. *United States,* 219 F.2d 682 (10th Cir. 1955).
527—Line 2: *Insert* voting *before* common.
545—¶2, line 6: *For* split-off, *read* split-up.
589–90: The illustration is erroneous, since the credit is the larger, rather than the sum, of (a) the amount retained for the reasonable needs of the business, and (b) $60,000 less the accumulated earnings and profits at the close of the preceding year. Thus, the credit on the facts stated would be $30,000, rather than $55,000.
599—Note ¶1, line 3: *For* §543(a)(8), *read* §545(b)(8).
604—Line 10: *For* this proportion, *read* his proportion.
620—Note ¶1: *Trousdale* v. *Commissioner* was affirmed, 219 F.2d 563 (9th Cir. 1955).
633—Note ¶1: A "feeder" corporation was held taxable under pre-1951 law, in *Eaton Foundation* v. *Commissioner,* 219 F.2d 527 (9th Cir. 1955), where the court stated: "The Ninth Circuit has not gone overboard in its application of [§101(6), 1939 Code]."
666—Note ¶2: *Pacific Grape Products* v. *Commissioner* was reversed, 219 F.2d 862 (9th Cir. 1955).
671—Note ¶2: §452 has been repealed retroactively. See S. Rept. No. 372, 84th Cong., 1st Sess. With respect to prepaid subscriptions, see *Beacon Publ. Co.* v. *Commissioner,* 218 F.2d 697 (10th Cir. 1955).
679—Note ¶1: I.T. 3956 has been revoked. Rev. Rul. 54–608.
679—Note ¶2: §462 has been repealed retroactively. S. Rept. No. 372, *supra.* This report states that *Pacific Grape Products* v. *Commissioner,* 219 F.2d 862 (9th Cir. 1955), reversing the Tax Court (casebook, p. 666), "might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed."
699—For another installment in *Ennis* v. *Commissioner,* see 23 T.C. No. 100 (1955).
707—Line 2: *For* §44(b) [1939 Code], *read* §453(b), 1954 Code.
712—Note ¶3, line 15: *For* §107(b) [1939 Code], *read* §1302, 1954 Code.
715—3d line from bottom: So in original, but "Government" should be "taxpayer."
716—Last paragraph: The following should be inserted between lines 2 and 3: is negative. According to this view, an operating loss is not a "true" loss if in the year in which it is incurred there is, for instance.
751—Note 2: *For* §7482(c)(2), *read* §7482(c)(1).
781–3—The Supreme Court decided a series of net worth cases on Dec. 6, 1954: *Holland* v. *U.S., Friedberg* v. *U.S., U.S.* v. *Calderon,* and *Smith* v. *U.S.,* 75 S. Ct. 127, 138, 186, and 194.
792—Last line: This line belongs at the end of the first paragraph of the extract from Stowe's article.
816—Line 5: *For* Section 3760 [1939 Code], *read* Section 7121 [1954 Code].
816—Line 6: *For* Section 3761 [1939 Code], *read* Section 7122 [1954 Code].
830—Last 2 lines: Transpose these lines.

FEDERAL INCOME
ESTATE AND GIFT TAXATION

Part 1

FEDERAL INCOME TAXATION

INTRODUCTION

A Bird's Eye View of American Tax History

The Sixteenth Amendment, empowering Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration," became effective on February 25, 1913. In the fiscal year 1913, the federal income tax on individuals and corporations produced $35 million of revenue, less than 5 per cent of total federal receipts, a modest amount when compared to the yield of about $320 million from the tariff. In the fiscal year 1955, however, the federal income tax will produce about $50 billion, some 80 per cent of total federal receipts and about 2½ times the amount of taxes collected by all state, county, and municipal governments in the United States combined. For the year 1913, a married couple with two children paid a federal income tax of $10 on a net income of $5,000, of $260 on a net income of $25,000, and of $25,010 on a net income of $500,000; for the year 1954, the tax bills for these incomes will be $520, $6,268, and $402,456.[1]

These facts are of great significance to the lawyer, as to other citizens. But of even more professional interest to him is the manner in which the federal income tax has come, during the last two decades, to affect every branch of the law. Leases, conveyances, and mortgages; wills, trusts, and deeds; employment contracts, collective bargaining agreements, and pension arrangements; corporate security issues, liquidations, and mergers—every one of these legal events is today permeated with, if not dominated by, tax problems. The traditional comparison of the partnership and the corporation as methods of carrying on business enterprise (limited liability, perpetual existence, *etc.*) is hopelessly inadequate if the federal income tax is disregarded; an alimony agreement that is drafted without one eye on the Internal Revenue Code will probably be badly drafted; and a sale of anything more valuable than a lame horse requires at least brief attention to the tax "angle." Taxes were once the province of accountants,[2] but today even the general practitioner of law must know his way around this area.[3] Nor is it only the practitioner who is affected by the Internal Revenue Code. The legal scholar who seeks to understand the rise of the sale and lease-back

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1 The figures for 1913 and 1954 are not precisely comparable, because of differences in exemptions, deductions, *etc.*, but the direction and degree of change are indisputable.

2 On the respective roles of the attorney and the accountant in federal income tax practice, see Rembar, "The Practice of Taxes," 54 *Col. L. Rev.* 338 (1954); Austin, "Relations Between Lawyers and Certified Public Accountants in Income Tax Practice," 36 *Iowa L. Rev.* 227 (1950).

3 On the ethical problems of tax practice, see Paul, "The Lawyer as a Tax Adviser," 25 *Rocky Mt. L. Rev.* 412 (1953), and works cited in footnote 2 thereof.

method of financing industrial and commercial property, or the growth of the family-controlled charitable foundation, or the use of multiple corporations to conduct a single enterprise must give due weight to the federal income tax. In its impact on our law for good or for ill, the federal income tax must be set down as one of the creative forces in legal history, like the invention of the trust, the corporation, or the doctrine of *respondeat superior*.

No other tax has had such an effect on the practice or structure of the law, at least not in our time. Many attorneys encounter the real property tax, which produces more than $8 billion a year for local governments, only at real estate closings, where its importance is minor; they may be acquainted with sales, use, and gross receipts taxes (producing about $6 billion for state governments) and with the federal taxes on alcohol and tobacco (about $4 billion per year) only as consumers; and no one will impugn the lawyer's professional competence if he goes through his career in ignorance of the customs duties. The federal income tax is something else again; he might better be ignorant of the rule against perpetuities, the parol evidence rule, or the requisites of negotiability.

How has this come about?

Until the Civil War, customs receipts were the backbone of the federal tax system; the only other source of federal income of any consequence was the sale of public lands, except for a miscellany of excise taxes imposed when customs receipts declined and expenditures increased during the War of 1812 and repealed shortly thereafter. During the Civil War, customs receipts were once again unable to carry the load, and it became necessary for Congress to seek other sources of federal revenue. Among the "war taxes" that it levied was an income tax. The measure was amended several times; the 1864 version imposed a tax of 5 per cent on incomes from $600 to $5,000, of 7½ per cent on income from $5,000 to $10,000, and of 10 per cent on income above $10,000. Income taxation was a useful supplement to customs and other levies, but total federal receipts still fell far short of expenses. There was a deficit of $423 million for the fiscal year 1862, and the annual deficit rose steadily until it amounted to $964 million for the year 1865. The Confederacy also employed an income tax, whose rates were steeper than the Union's, but its yield was much lower.

After the Civil War, the federal income tax was repealed and customs receipts once again became the basic source of federal revenue; but they were never again to be the only source. Federal excises on tobacco and liquor together produced almost as much as, and sometimes even more than, the tariff during the years between the Civil War and World War I. Throughout the seventies and eighties, moreover, agrarian and labor groups called for reductions in the tariff and for a revival of the federal income tax. To Eastern business interests, on the other hand, the income tax was "confiscation," "spoliation," and "communism," and throughout this period the Republican Party held the fort against its assaults. The task became harder as the Democratic Party gradually emerged from its handicap as the party of secession, and it finally became impossible when the Populist movement gained strength from the panic of 1893.

In 1894, during Cleveland's second administration, a federal income tax, based largely on the Civil War statute, was passed by Congress after a bitter struggle, a notable feature of which was the oratory of William Jennings Bryan. A tax of 2 per cent was imposed on individual income over $4,000 and a flat 2 per cent tax

was imposed on the income of business corporations. Congress thus went far beyond Cleveland's modest recommendation, in his 1893 message to Congress, of a "small tax upon incomes derived from certain corporate investments." The income tax was carried by Democratic and Populist votes, but it must be viewed primarily as a regional victory of the South and Middle West over the Northeast, part of the same sectional movement that produced the Interstate Commerce Act in 1887, the Sherman Antitrust Act in 1890, and the unsuccessful campaign for bi-metallism. It is worth noting, however, that the Populist effort to obtain a progressive tax on individual income was defeated, though the $4,000 exemption introduced a measure of graduation.

The tax became law on August 28, 1894[4] to take effect as of January 1, 1895, and by January 29, 1895, the Supreme Court had agreed to hear *Pollock* v. *Farmers' Loan & Trust Co.* (and a companion case), in which the Circuit Court for the Southern District of New York had refused to grant an injunction in an action that attacked the tax as unconstitutional. Immense public interest was aroused by the five days of argument before the Supreme Court, in which notable attorneys and orators were engaged on both sides. The *Pollock* action was a suit by a stockholder to enjoin his corporation from paying the tax, a legal form that has been much criticized and is seldom encountered today.[5] Consequently, the tax was defended not only by the Attorney General but also by counsel for the corporation.

One ground of attack was that the income tax was a "direct" tax, and that it was not apportioned among the several states in proportion to population, as required by Article I, Section 9, Clause 4 of the Constitution:

> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

A "capitation" tax clearly meant a poll tax, and there was general agreement that a tax on real estate, the kind that produces the bulk of municipal revenue today, was also a "direct tax" as that term was used in the Constitution. But was the income tax a "direct" tax because it included rents received by the owner of real property, along with all other types of income? If an income tax on rents derived from real property was a "direct" tax, was the inclusion of income from personal property (*i.e.*, interest from bonds, dividends from stock, etc.) equally invalid? Finally, if the inclusion of rentals or dividends and interest made the tax "direct," were these provisions separable from the rest of the tax, or was the statute invalid *in toto?*

Whatever may have been the purpose of the constitutional requirement that direct taxes be apportioned among the several states in relation to their population,[6] it was jeopardized by the lack of a consensus on what, besides a poll tax and a tax on real property, was included in the term "direct tax." Chief Justice Fuller was surely mistaken when he said in the *Pollock* case (157 U.S. at 573)

[4] Without President Cleveland's approval. The tax was a rider to the Wilson tariff bill, and Cleveland opposed the imposition in it of tariffs on sugar and other commodities. But since a veto would have kept alive the McKinley tariff schedules, Cleveland allowed the act to become law without his approval.

[5] *Infra*, Chapter 9, Section B.

[6] In the *Pollock* case, Chief Justice Fuller explained the provision's purpose as follows: "Nothing can be clearer than that what the Constitution intended to guard against was the exercise by the general government of the power of directly taxing persons and property

that "the distinction between direct and indirect taxation was well understood by the framers of the Constitution and those who adopted it." More descriptive of the prevailing uncertainty is this extract from Madison's *Notes:* "Mr. King asked what was the precise meaning of *direct* taxation. No one answered." [7]

The term "direct tax" had caused difficulty at the very outset of the Republic. In 1794, Congress levied a tax on carriages, after a debate in which Madison argued that the tax was a direct one, while Fisher Ames, drawing on Massachusetts experience, asserted that it was indirect. The Supreme Court, in a case [8] in which ex-Secretary of the Treasury Hamilton participated in the argument, held that the tax was constitutional. Mr. Justice Chase was "inclined to think" that the only taxes that were "direct" within the meaning of the Constitution were the poll tax and taxes on land. Expressing doubt that a tax on personal property was "direct," he found that it was not necessary to decide, because "a tax on expense is an indirect tax; and I think, an annual tax on a carriage for the conveyance of persons, is of that kind. . . ." (3 Dall. at 174.) Mr. Justice Paterson and Mr. Justice Iredell, who wrote separate opinions, were equally unable to suggest any examples of a direct tax except the poll tax and taxes on land.

So far as federal income taxation was concerned, the Supreme Court's most important foray into the morass before the *Pollock* case was *Springer* v. *United States,* 102 U.S. 586 (1880). In this case, the Court unanimously upheld the validity of the Civil War income tax, which embraced (13 Stat. 479):

> the annual gains, profits, and income of every person . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation . . . or from any other source whatever.

Citing the *Hylton* case, and other cases in which it had held that taxes on the receipts of insurance companies, on state bank notes, and on inheritances were all indirect taxes, the Court held that the federal income tax was also indirect, saying (102 U.S. at 602):

> Our conclusions are, that *direct taxes,* within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty.

Despite this history, the Supreme Court in the *Pollock* case, by a vote of six to two (one justice not sitting), held that insofar as it taxed income from real estate, the 1894 federal income tax was unconstitutional:

> . . . [I]t is admitted that a tax on real estate is a direct tax. Unless, therefore, a tax

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within any State through a majority made up from the other States." 157 U.S. at 582. Seligman, on the other hand, concluded that the restriction was concerned only with the slavery question: it was intended to induce the slave states to accept representation in the lower house of Congress based on the number of free persons in the state plus only three-fifths of the slaves, by promising that direct taxes would be similarly apportioned. This link between representation and direct taxation is clearly seen in Article 1, Section 2, Clause 3 of the Constitution: "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, . . . three fifths of all other Persons." Seligman comments: "The direct-tax clause was inserted into the constitution simply and solely as a concession to slavery, and with the disappearance of slavery and the adoption of the fourteenth amendment the very reason of its existence passed away." Seligman, *The Income Tax* (1911) 559.

[7] 5 Elliot, *Debates on the Adoption of the Federal Constitution* (1866) 451.

[8] Hylton v. United States, 3 Dall. 171 (1796).

upon rents or income issuing out of lands is intrinsically so different from a tax on the land itself that it belongs to a wholly different class of taxes, such taxes must be regarded as falling within the same category as a tax on real estate *eo nomine*. . . . An annual tax upon the annual value or annual user of real estate appears to us the same in substance as an annual tax on the real estate, which would be paid out of the rent or income. . . . If, by calling a tax indirect when it is essentially direct, the rule of protection could be frittered away, one of the great landmarks defining the boundary between the Nation and the States of which it is composed, would have disappeared, and with it one of the bulwarks of private rights and private property. (157 U.S. at 580, 581, and 583.)

The *Springer* case was distinguished because none of the income of the taxpayer there in question was derived from real estate, a factual distinction that was accurate but that probably would have come as a surprise to the *Springer* court.

In addition to holding that the inclusion of rents was unconstitutional, the Court in the *Pollock* case decided, all eight justices agreeing, that the inclusion of municipal bond interest constituted "a tax on the power of the States and their instrumentalities to borrow money" and that it was unconstitutional as a violation of the federal principle. This determination was not of fundamental importance, because an income tax exemption for interest from state and municipal bonds was entirely feasible (and, indeed, all subsequent income taxes have exempted such income). It might even have been possible to re-enact a federal income tax with an exemption for income derived from real property. But two other questions were left unanswered because the Court was equally divided, and so long as these questions were in doubt, re-enactment of an income tax law was hardly likely. The first was whether a tax on income from personal property was an improper direct tax. This was a fundamental issue because if not only rents but also interest and dividends had to be granted an exemption, a federal income tax would have to be restricted to personal earnings and business profits. Secondly, the Court did not decide whether the granting of a minimum exemption of $4,000 to individuals violated the uniformity clause of Article I, Section 8, Clause 1 of the Constitution: "[A]ll Duties, Imposts and Excises shall be uniform throughout the United States." This issue too was basic. A third question of great immediate importance was also left unanswered by an equally divided Court: whether the invalid provisions taxing income from real estate and municipal bond interest were separable from the rest of the statute or rendered it invalid *in toto*.

One week later, counsel for the appellants applied for a rehearing on the undecided questions, and the Attorney General in response suggested that the whole case be reargued. The Court set both applications for rehearing down for argument in May, 1895; this time all nine justices were on the bench. In a second opinion (158 U.S. 601), the previous holding as to income from real estate was reaffirmed by a vote of five to four. The same five justices agreed that a tax on the income from personal property was an invalid direct tax, and they held that the invalid provisions were not separable from the rest of the tax, so that the tax was invalid *in toto*.[9] Mr. Justice Jackson, who did not sit on the

[9] The Court did not find it necessary to pass on the other undecided question—did the $4,000 exemption violate the uniformity clause of Article I? A few years later, however, in *Knowlton* v. *Moore*, 178 U.S. 1 (1900), the Supreme Court held that a federal inheritance tax was constitutional despite certain exemptions; the term "uniform throughout the United States," it held, meant geographical uniformity, so that persons and property would be taxed in the same manner without regard to geographical location, rather than "intrinsic" uniformity (*i.e.*, without exemptions).

first argument, voted to uphold the tax on all three counts. Since he was part of a minority of four, it was immediately assumed that one of the four justices who at the first argument thought the tax on income from personal property was proper and that the provision taxing rents was separable from the rest of the statute must have switched sides. This in itself would not have been of earth-shaking importance, but it was dramatic evidence of the power of a single judge, and the fact that the reports did not reveal the name of the "vacillating" judge lent an air of mystery to the event. Mr. Justice Shiras was long identified, on what now seems to be slim evidence, as the judge who switched, though some scholars have more recently awarded the blame, or credit, to others. It is also possible that the assumption of a switch is incorrect.[10]

After the *Pollock* decision, advocates of the income tax turned to an amendment to the Constitution as a means of reviving the tax, though there was also some agitation for confronting the Supreme Court with a new statute in the hope of securing a reversal of the judicial position. McKinley's victories in 1896 and 1900 over William Jennings Bryan, the candidate of the Democrats and Populists, reflected the temper of the times, however, and not even the financial demands of the Spanish-American War could restore the federal income tax. But within a few more years after the *Pollock* case, in which Mr. Justice Field had called the income tax "usurpation," an "assault upon capital," and "the stepping-stone to . . . a war of the poor against the rich" (157 U.S. at 607), the very same tax had found eminent support within the Republican Party itself: both Theodore Roosevelt and William Howard Taft announced that they favored a federal income tax. Taft, indeed, expressed at one time the view that a constitutional amendment might not be required because of the changed membership on the Supreme Court, though he later reconsidered. Bryan, apparently having more faith in the rule of precedent than the future Chief Justice, insisted that a constitutional amendment was necessary, and that Taft's hope of a change in the Supreme Court's sentiment was insincere. Whether Taft himself was engaged in a campaign maneuver or not, the insurgent Republicans who followed Roosevelt were unquestionably serious.

In 1909, a combination of these insurgent Republicans and the Democrats laid plans for an income tax amendment to the Payne-Aldrich Tariff bill, then pending in the Senate. The proposal was a tax on both corporate and individual incomes, with a $5,000 exemption; it was a direct challenge to the *Pollock* case, except that interest from state, county, and municipal bonds was to be excluded, in recognition of the Supreme Court's unanimity on this point. The conservative wing of the Republican Party was able to head off the threat by winning over President Taft, but the price of victory was high. To obtain Taft's assistance in beating down the income tax on individuals, its opponents were forced to agree that Congress would enact a tax on corporate income[11] and that it would adopt

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[10] There is a full account of the puzzle and a review of earlier comments in Shiras, *Justice George Shiras, Jr. of Pittsburgh* (1953) 168–183.

[11] The 1909 corporate income tax was held constitutional in Flint v. Stone Tracy Co., 220 U.S. 107 (1911). The Court rejected (220 U.S. at 150) the argument that it imposed an unapportioned "direct" tax:

"Within the category of indirect taxation, as we shall have further occasion to show, is embraced a tax upon business done in a corporate capacity, which is the subject-matter of the tax imposed in the act under consideration. The *Pollock* case construed the tax there

a joint resolution proposing to the States an amendment to the Constitution to permit a federal income tax on individuals. Taft favored the constitutional amendment partly as a sop to the insurgents and partly because he thought that an income tax might be good policy in time of great national need. The backers of the income tax were dismayed by Taft's open opposition and especially by the fact that a constitutional amendment could be defeated if only 12 state legislatures were won over by the conservatives.[12] Moreover, even with an amendment to the Constitution, the battle in Congress would have to be fought again, perhaps at a less auspicious time.

The joint resolution passed by Congress in 1909 on Taft's insistence, adopted in time as the Sixteenth Amendment to the Constitution, was in the following terms:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The most influential opposition to the proposed amendment, when it was before the states for ratification, stemmed from a special message on January 5, 1910, from Governor Charles Evans Hughes to the New York State Legislature. Governor Hughes stated that he believed the federal government should have the power to impose an unapportioned income tax, but he recommended against ratification because the words "from whatever source derived" in the proposed amendment, "if taken in their natural sense," would permit income from state and municipal bonds to be taxed by the federal government, a power that would "afford the opportunity for federal action in violation of the fundamental conditions of State authority." This message led to the defeat of ratification in New York in 1910. Some supporters of the amendment rejected Hughes' construction, but others were willing to accept it, and his views were quoted throughout the nation. But the Democrats and insurgent Republicans were successful in the state elections of 1910 (New York ratified in 1911) and again in 1912, and by early 1913 thirty-six states had ratified.

The Sixteenth Amendment thus became a part of the Constitution on February 25, 1913, less than four years after the advocates of the income tax thought they

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levied as direct, because it was imposed upon property simply because of its ownership. In the present case the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax, measured by the standard prescribed. The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way."

The Court also upheld (220 U.S. at 162) the inclusion of income from state and municipal bonds:

"It is further contended that some of the corporations, notably insurance companies, have large investments in municipal bonds and other non-taxable securities, and in real estate and personal property not used in the business, that therefore the selection of the measure of the income from all sources is void, because it reaches property which is not the subject of taxation—upon the authority of the *Pollock* case, *supra*. But this argument confuses the measure of the tax upon the privilege, with direct taxation of the estate or thing taxed. In the *Pollock* case, as we have seen, the tax was held unconstitutional, because it was in effect a direct tax on the property solely because of its ownership."

[12] Amending the Constitution seemed a graver and more formidable undertaking then than now; the first ten amendments were virtually part of the original Constitution, the eleventh and twelfth had been adopted in 1798 and 1804, and for more than a century the only other amendments were the thirteenth, fourteenth, and fifteenth, representing the political settlement of a civil war.

TABLE I

YEAR	FEDERAL INCOME TAX PAID BY MARRIED COUPLE WITH TWO DEPENDENTS ON A NET INCOME OF: *						TOTAL FEDERAL COLLECTIONS FROM: †		NET FEDERAL RECEIPTS ″ (In Millions)	TOTAL FEDERAL EXPENDITURES # (In Millions)
	$2,000	$5,000	$10,000	$25,000	$100,000	$500,000	Individual Income Tax ‡ (In Millions)	Corporation Income and Excess Profits Tax § (In Millions)		
1913	....	$ 10	$ 60	$ 260	$ 2,510	$ 25,010	$35		$ 724	$ 725
1917	....	64	339	1,764	16,164	192,664	$ 180	$ 207	1,124	1,978
1918	....	156	782	3,672	34,982	322,982	2,852		3,665	12,697
1919	....	104	558	2,848	31,158	303,158	2,601		5,152	18,515
1920	....	104	558	2,848	31,158	303,158	3,957		6,695	6,403
1925	....	8	83	1,129	16,029	116,029	845	916	3,780	3,063
1930	....	8	83	994	15,739	115,739	1,147	1,263	4,178	3,440
1935	....	48	343	2,327	30,162	263,464	527	578	3,730	6,521
1940	....	75	440	3,571	42,948	329,637	982	1,148	5,265	9,183
1941	....	271	1,117	6,480	52,160	344,476	1,418	2,054	7,277	13,387
1942	$13	592	1,914	8,814	63,479	413,384	3,263	4,744	12,696	34,187
1943	58	730	2,208	9,574	67,803	439,931	6,630	9,689	22,202	79,622
1944	45	755	2,245	9,705	68,565	442,985	18,261	14,767	43,892	95,315
1945	45	755	2,245	9,705	68,565	442,985	19,034	16,027	44,762	98,703
1946	....	589	1,862	8,522	62,301	406,600	18,705	12,554	40,027	60,703
1947	....	589	1,862	8,522	62,301	406,600	19,343	9,677	40,043	39,289
1948	....	432	1,361	5,476	45,643	358,677	20,998	10,174	42,211	33,791
1949	....	432	1,361	5,476	45,643	358,677	18,052	11,554	38,246	40,057
1950	....	452	1,417	5,672	47,208	369,645	17,153	10,854	37,045	40,167
1951	....	530	1,622	6,406	52,640	403,408	22,997	14,388	48,143	44,633
1952	....	577	1,774	7,004	56,032	411,224	29,274	21,467	62,129	66,145
1953	....	577	1,774	7,004	56,032	411,224	32,536	21,595	65,218	74,607
1954	....	520	1,592	6,268	51,912	402,456	33,433**	22,809**	67,628**	70,902**
1955							30,908**	19,694**	62,642**	65,570**

* SOURCE: *Statistical Abstract of the United States* (1953) at p. 352. Net income equals gross income less all personal and business deductions.

† These figures are based on the gross collections actually made by collecting officers in the field during the fiscal period specified. Thus they include collections of delinquent taxes due in prior years. Separate figures for individual and corporation taxes are not available for the years 1913 or 1918–1920.

‡ SOURCE: *Annual Reports of the Secretary of the Treasury on the State of the Finances* (1929) at p. 420, (1947) at p. 310, and (1953) at pp. 18, 371.

§ SOURCE: *Ibid.* Excess profits taxes were imposed only in the years 1917–1922, 1940–1945, and 1950–1953. They were imposed on that portion of business profits which was regarded as excessive in relation to the corporation's invested capital or to its earnings in an earlier base period.

″ SOURCE: *Id.* (1953) at pp. 330-332; *Treasury Bulletin* (February, 1954) at p. 1. Net receipts equals total receipts from all sources less (1) appropriations to the Federal Old-Age and Survivors Insurance Trust Fund and (2) refunds of receipts. The figures for years prior to 1930, however, are for total receipts, since net receipts figures are unavailable.

\# SOURCE: *Ibid.* Does not include statutory debt retirements, refunds by the government (principally for overpayment of taxes), or certain intergovernmental capital transfers.

** Estimates.

had been defrauded of victory by the maneuver of the tax's opponents. Within a few months, moreover, Congress passed the Revenue Act of 1913, imposing a "normal" tax of 1 per cent (with an exemption of $3,000 for an individual and of $1,000 additional for a married person living with his spouse) and a "surtax" ranging from 1 per cent on net income from $20,000 to $50,000 up to 6 per cent on that part of any net income exceeding $500,000. This should be compared with the income tax proposal that was defeated in 1909: a flat 2 per cent on net income in excess of $5,000.

The Role of the Income Tax Today: A Brief Survey

The income tax's career from 1913 to the present day is starkly summarized in Table I.

Where do we go from here? In answering this question, we might begin by analyzing the last column of Table I—the expenditures of the federal government. These expenditures, broken down for the period since World War II, are shown in Table II.

TABLE II

TOTAL EXPENDITURES BY MAJOR CLASSIFICATIONS
ALTERNATE FISCAL YEARS 1947–1955*
(In Millions)

	1947	1949	1951	1953	1955 †
National Defense and Related Activities	$16,812	$12,158	$19,955	$44,584	$38,271
International Finance and Aid	4,928	6,016	4,469	5,788	5,250
Interest on the Public Debt	4,958	5,339	5,613	6,508	6,800
Veterans Administration	7,259	6,878	5,333	4,335	4,165
Agriculture	1,226	2,658	635	3,063	2,523
Commerce	149	239	378	477	421
Housing and Home Financing	129	−56	460	382	−385
Postal Deficiency	242	524	624	660	90
Public Works	690	1,519	1,458	1,655	1,471
Reconstruction Finance Corporation	215	314	−71	−86	−238
Social Security Program	1,066	1,696	2,027	2,253	1,525
Atomic Energy Commission	159	647	908	1,802	2,425
Miscellaneous	1,456	2,124	2,844	3,185	3,253
Total	$39,289	$40,057	$44,633	$74,607	$65,570

* SOURCE: *Annual Report of the Secretary of the Treasury on the State of the Finances* (1953) at pp. 366-367; *Treasury Bulletin* (February, 1954) at pp. 2, 4.

† Estimates.

What are the prospects for a massive reduction in these expenditures—not by substituting paper napkins for linen on naval flagships, but by fundamental cuts in the budget? Much of our budget obviously hinges on the men in Moscow and Peiping, not on Bostonians and San Franciscans. A dependable international settlement would have a prompt repercussion on federal expenditures, and so would further aggression. Our expenditures for national defense and foreign aid reflect our international hopes, aims, and estimates. These in turn are partly

trimmed to our economic position, but not even those who believe that the Kremlin's long-range strategy is to lure us into "bankruptcy" would recommend a cessation of defense expenditures to improve the national financial statement. Other important items in the federal budget, like veterans' benefits and interest on the public debt, can be reduced only painfully. The prospect for a substantial cut in these expenditures is dark. Still other domestic expenditures are more flexible, but social aims, regional and occupational pressures, political pledges and ambitions, and kindred drives may lead to increases instead of to reductions. Moreover, if expenditures that aid one group (farmers, veterans, tenants of public housing developments, *etc.*) are—or seem to be—financed by taxes on other groups, the pressure to cut expenditures may be decisively overbalanced by the drive to increase benefits. Of course, the favored group, conscience-stricken, may advocate a reduction in its benefits, but such a subversive refusal to play the economic man may be matched by an infection of altruism within the taxed group, causing them to insist on increasing the benefits paid to the others. Last year's level of federal expenditures is not sacrosanct; one has only to examine the last column of Table I to see how widely expenditures can vary from decade to decade. But Tables I and II also demonstrate that our international interests, aspirations, and responsibilities are of overwhelming importance in fixing the level of national expenditures.

So much for the expenditure side of the federal budget. What of federal taxes? While the two items are related, they are certainly not in balance. Though expenditures decline, taxes may be held up to produce a surplus for debt retirement, to combat inflation by draining off funds that might be used for consumer goods, or for other reasons. Conversely, taxes might be cut without a corresponding decline in expenditures, the gap being closed by government borrowing. Such a fiscal policy might be adopted in a depression in order to stimulate the national economy by government spending; deficit financing may also be resorted to in wartime, to finance expenditures essential to national survival, if taxes are already as high as is politically or economically feasible. A gap between federal expenditures and federal taxes, then, is not only possible but may be a deliberately adopted policy. Still, one cannot minimize the facts that, on the one hand, there is strong opposition to deficit financing, while, on the other hand, any decrease in federal expenditures will stimulate a demand that the "saving" be "passed on" to the taxpayer. The bond between taxes and expenditures cannot be ignored, then, though it may be more of an uneasy family tie than an inflexible chain. Without a drastic change in federal expenditures, a drastic change in total federal taxes is unlikely.

To be sure, the taxpayer's readiness to accept heavy federal expenditures will be molded not only by his assessment of their short and long run value to him, but also by the type of tax imposed to finance the expenditures. A tax that is out in the open, like an income or sales tax, may cause more resistance to federal expenditures than one that is less clearly identifiable—like a manufacturer's excise, though even the latter type of tax, if separately stated by the vendor of products or services, may produce "tax consciousness" on the consumer's part. An income tax paid once a year may be a crushing blow, while the same amount

withheld from wages may not be missed, as though gross wages were a mirage and "take-home" pay the only reality. On the other hand, if the tax is hidden, some taxpayers may be uneasy about expenditures they would endorse if they knew where the money was coming from; and still others, feeling that the income tax withholding system is fit only for serfs and school children, may protest any expenditures by a government that will not trust them until the annual due date. The distribution of the burden among economic and regional groups and the taxpayer's sense of justice also affect the likelihood of a taxpayers' movement for the reduction of expenditures. While a taxpayers' revolution is always possible, the author's own, no doubt unforgiveably cynical, conclusion is that the users of the mail are about as likely to band together to force a reform of the postal service.

If federal expenditures, and hence federal taxes, remain high, what part will the federal income tax play in the foreseeable future? Its phenomenal success in raising revenue cannot be disputed, but its position of pre-eminence has not gone unchallenged. Some critics argue that it is dangerous for the federal government to rely so heavily on a tax whose yield is entirely at the mercy of national income, so that any decline in income will produce an immediate decline in revenue.[13] To others, however, this "built-in-flexibility," far from being a drawback, is one of the merits of the income tax; the automatic decline in tax liability when income falls serves to release consumer spending power when it is most needed, without the delay of political action, while in a period of boom, the automatic rise in tax liability serves to reduce the inflationary pressure of increased purchasing power.

The most vigorous attacks on the pre-eminence of the federal income tax, however, have come from those who fear its strength, not its instability. In part, the fear is that the income tax undermines the incentive to work. The criticism is not easily assessed, and the task is not made less perplexing by the fact that many of the critics are academic economists, who, if they are themselves motivated by financial ambition, have shown poor judgment, and lawyers, among whom the tradition of uncompensated public service is strong. Some taxpayers are indifferent to money; but others, no doubt, are indifferent to everything else. Even those who do not themselves care much for money, of course, may be goaded into lethargy by the government's demands for part of what they earn. Of those taxpayers who are driven principally by ambition for financial success, some may work harder under the lash of the income tax to maintain a stable after-tax income, while others may flee to Florida or Tahiti or to jobs that require less energy. While in general it is thought that an income tax on wages and salaries cannot be shifted by the taxpayer, it may be that some groups, *e.g.*, organized labor, may demand higher pay for the same work, leaving their incentives untouched by the tax, except insofar as the whole economy eventually reflects the higher cost of labor. The income tax's impact on incentives is unquestionably also affected by the purpose for

13 A decline of 10 percent in the adjusted gross income of individuals below the 1953 level, it has been estimated, would reduce tax liabilities by $4 billion, from $32 billion to $28 billion. A decline of 25 per cent in individual income would cut tax liabilities from $32 billion to $22 billion. Pechman, "Yield of the Individual Income Tax During a Recession," 7 *Nat. Tax J.* 1, 13 (1954).

which the tax is levied, the climate of political opinion, the steepness of any increase, the prospects for later changes in tax rates, the taxpayer's sense of justice, *etc.*

If we assume that the federal income tax impairs the incentives of persons who can join or withdraw from the labor market with comparative freedom—like men near retirement age or housewives, one must still decide whether it is undesirable for housewives to turn down factory jobs or for business executives to accelerate their retirement. Opinions would surely differ, and we cannot avoid the question by saying that such decisions should be left to the individual without coercion by the tax system. All taxes have effects on the economy, and if the income tax were reduced or repealed to encourage the housewife or older executive to work, some other tax would have to be imposed, or deficit financing would have to be resorted to, and the taxpayer would then be coerced in some other area of his economic life. We know little of the incentive effects of income taxation,[14] but even if we knew much more, policy decisions would not flow inexorably from the information.

Economists seem to feel on more solid ground when they turn from the impact of income taxation on incentives to its effect on consumption and savings. Assuming that the tax is not shifted, as by a successful demand for higher wages or salaries, the usual view is that it deprives low income taxpayers of funds that would go for consumer goods and services, while high income groups are impelled to reduce their savings rather than their consumption. This conclusion rests on the assumption that low incomes are largely or entirely exhausted by consumption expenditures, saving being either nil or confined to relatively inelastic items like insurance premiums. Higher income groups devote increasingly large portions of their income to savings, it is thought, and hold their consumption at relatively inflexible levels. Our knowledge of the distribution of investments among income groups is quite fragmentary, but one recent study presented these conclusions:

> 1. That, as a minimum estimate, the top 1 per cent of all spending units with incomes of about $15,000 and over accounted for more than one-quarter of the annual accumulations of investable funds made by all spending units in 1948 and presumably also in other postwar years.
>
> 2. That, again as a minimum estimate, the top 3 per cent of all spending units with incomes of $10,000 and over accounted for more than 40 per cent of the total.
>
> 3. That the top 5 per cent of all spending units with net incomes of $7,500 and over accounted for more than 55 per cent of the total.[15]

These estimates of 25 per cent, 40 per cent, and 55 per cent as the annual accumulations of investable funds by the top 1 per cent, 3 per cent, and 5 per cent were regarded by the authors as minimums that might more probably be stated as 30-35 per cent, 45-50 per cent, and 60-65 per cent respectively.

Though these statistics indicate a high degree of concentration of "investable

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[14] A recent study of business executives found some evidence of an adverse effect of income taxation on incentives, but it also states: "The evidence of the interviews tends to show that the extent to which business executives have reduced their work and effort, as a result of taxes, has frequently been much exaggerated. . . What all history goes to show is again confirmed by a good deal of evidence in this study, that difficulty, danger, and strenuous effort are themselves incentives to many men." Sanders, *Effects of Taxation on Executives* (1951) 12, 14.

[15] Butters, Thompson, and Bollinger, *Effects of Taxation: Investments By Individuals* (1953) 19.

funds," they also indicate that some 65-75 per cent of the annual accumulation of such funds is diffused among the 99 per cent of spending units with incomes of under $15,000. The income tax even at present rates is hardly confiscatory at the level of $15,000 and below, and these are the families that would have to bear the brunt of any alternative tax that might be levied to replace the federal income tax. Would their investment capacity be enhanced, or reduced, if Congress turned its affections from the income tax to a national sales or manufacturers' excise tax? One must not overlook, of course, the apparent fact that the higher income groups, on whom the income tax rests more heavily, invest increasingly higher portions of their investable funds in risk ventures, without which there can be no sound investment of lower class money; and it is also possible that lower income groups keep disproportionately large parts of their savings in the form of cash rather than in investments. But we may be seeing a shift in this pattern, as insurance companies, pension funds, investment companies, and other pools of capital that are fed by lower income groups exhibit an interest in the type of business equities that they once avoided as imprudent investments. Moreover, installment investment plans for lower income groups may introduce an element of inelasticity here, at least so long as wages exceed the subsistence level. It is not inconceivable that we will become a nation of mass investment, as well as mass purchasing, power. If that time is already at hand, we shall have to rethink, and perhaps to revise, our views of the relation of income taxation to savings and investment.

Individuals are not the only source of funds for investment, of course, and they may not even be the most important. Corporate investment in recent years has been financed by retained earnings more than by the sale of securities. The corporate income tax reduces earnings available for investment, though this pressure may be alleviated to some unknown degree by a shifting of the tax through the medium of higher prices or lower wages. It may also be alleviated by a reduction in dividends, though this expedient, while conserving the corporation's internal resources, would repel outside capital. Besides reducing the supply of corporate capital for investment, an income tax may reduce the incentive to invest. Generalizations in this area are but faint guideposts to national policy, however, without differentiation according to the size, age, and risk of the enterprise. In its present form, the federal income tax may encourage investment in bonds rather than in stocks, and in tax-exempt state and municipal bonds rather than in taxable securities, but these effects, which will be adverted to later in this book, are more adventitious than central to income taxation.

As has already been indicated, the attempt to measure or predict the effect of income taxation on the drive to work and on the pattern of consumption, savings, and investment, is complicated by the rudimentary state of our knowledge about the incidence of taxation. Does the burden of an income tax rest on the person who pays it, or can he shift the burden, in either the short or the long run, to others? Traditionally it has been thought that an income tax on business profits cannot be shifted either by cutting wages or other costs or by raising prices, because the taxpaying business must compete with the marginal firm that, because it is just breaking even, pays no income tax, and fixes its prices (and therefore its competitors') without regard to the tax. In recent years, however,

some economists have been less sure that the marginal firm sets the pace for the others; and, even if it theoretically would do so under conditions of perfect competition, the intervention of monopolistic advantages (trade names, unique locations, other forms of good will, etc.) will in practice greatly modify the role of the marginal producer. It may be that even with such advantages, the most profitable price prior to the levy of an income tax will still be the most profitable price afterwards, so that the tax could be the occasion but not the cause of increased prices. But if the firm has not previously pressed its advantages home and is impelled to do so by the tax, the tax has in a very real sense been "shifted." The chairman of the finance committee of the U. S. Steel Corporation and the research department of the C.I.O. have both asserted that corporate income taxes are costs that are passed on to the public in the form of higher prices,[16] and one must think twice before rejecting these empirical opinions in favor of a contrary position that is derived from an economic "model" that may have no counterpart in real life. An income tax that was shifted would, of course, have very different effects upon incentives, savings, and investment from one whose burden remained on the taxpayer.

Many economists who reject the possibility of a short-run shifting of an income tax acknowledge that it may be shifted in the long run. If the marginal firm is earning no profits, they reason that it will be induced to transfer its investment to a sector of the economy where a return can be realized, thus curtailing supply in the old area, while no new funds will flow there until prices have risen sufficiently to offer a profit. These effects can be felt only as fast as the marginal firms can, and will, liquidate. Similarly, the traditional view has been that an income tax on wages cannot be shifted. But a strong union's insistence on stable "take-home" pay will surely have some effect, at least in the short run. When we look beyond the immediate consequences of such institutional pressure, however, we find that increased wages will in turn affect prices, consumption, and investment, and predictions become precarious indeed.

The principle of progression in the federal income tax has always been controversial, but in the last few years it has been more severely criticized than at any time since the formative years of the tax. For several decades, the opponents of progression were, if not acquiescent, at least quiescent. Just as many supporters of the tax look on progression as its greatest virtue (though they may disagree about the proper rate of progression), so many of its critics have come to think that this is its worst characteristic; and, unquestionably, a proportional income tax would be palatable, and perhaps even attractive, to some of them. Progression is inescapable if any personal or dependency exemptions are allowed, a practice as old as the British income tax of 1799, and a more deliberate form of progression also has some eighteenth and early nineteenth century antecedents. But not until the Civil War income tax (both in the North and the South) can significant graduation be found, and this was only the primitive origin of what is now, as Table I indicates, a fine art.[17] As the student will soon dis-

[16] Goode, *The Corporation Income Tax* (1951) 44-45.

[17] In point of fact, the degree of actual (as opposed to nominal) progression in the federal income tax is open to dispute (partly because of the flat 25 per cent tax on capital gains, the exclusion of interest from state and municipal bonds, and other specially treated items), and even more uncertain is the extent of progression in the aggregate national tax burden. See Musgrave, Carroll, Cook, and Frane, "Distribution of Tax Payments by Income Groups: A

cover, many of the most troublesome administrative and legal problems created by the federal income tax are the direct result of progression; these difficulties and complications may not in themselves count heavily against progression, if it can be defended on more fundamental grounds, but they do force us to think about whether a progressive tax has advantages over a proportional tax that would be much simpler.

Is progression justified? The taxes on cigarettes, whiskey, retail sales, and real property are the same for each taxable item and taxpayer. If the taxpayer's purchases increase in number or his property in value, he pays proportionately, not progressively, more. If the tax on the third martini is no more than the tax on the first, why should the millionth dollar of income in a given year be taxed more heavily than the ten-thousandth? A number of arguments for progression have been put forward; some are variations on the "sacrifice" theory, assuming that it is less painful to relinquish the last dollar of a high income than the last dollar of a lower income, an idea that is popularly expressed in the phrase, "ability to pay"; some rest on the assumption that the benefits "bought" with taxes increase progressively with the taxpayer's income or wealth; sometimes there are appeals to equalitarian principles; and sometimes it is argued that progression contributes to a better balance between savings and consumption in the economy. None of the purely "rational" arguments are entirely satisfactory; either they rest on premises that are intuitive rather than demonstrable, or they carry implications that go far beyond progressive taxation alone. It seems likely that the emotional and ethical appeal of progression is ultimately more persuasive; but, of course, it is less susceptible to analysis. The authors of a recent painstaking examination of the intellectual history of progression concluded that the case for progression "turns out to be stubborn but uneasy."[18] The strength of conviction in this area is amply demonstrated by the reviews of their study. John Chamberlain,[19] in whose eyes the Sixteenth Amendment "legalizes a theft," welcomed the book for conferring "academic recognition" on "the intellectual sapping operation against the progressive principle." Randolph Paul,[20] on the other hand, tells us that the book "has confirmed rather

Case Study for 1948," 4 *Nat'l Tax J.* 1 (1951); Tucker, "Distribution of Tax Burdens in 1948," *id.* at 269; Musgrave and Frane, "A Rejoiner to Dr. Tucker," 5 *id.* at 15 (1952); Colm and Wald, "Some Comments on Tax Burden Comparisons," *id.* at 1. These articles cite several earlier studies. See also Neisser, "The Dynamics of Tax Burden Comparisons," *id.* at 351. For an attempt to gauge the net redistributive effect of the American fiscal system, taking into account not only tax burdens but also the receipt of benefits by income groups, see Adler, The Fiscal System, the Distribution of Income, and Public Welfare, in Poole, *Fiscal Policies and the American Economy* (1951) 359. Any calculation of the degree of progression in the American tax structure must come to grips with the question of shifting, since if the burden of the tax does not rest on the taxpayer, the effect of progression is minimized or obliterated.

18 Blum and Kalven, *The Uneasy Case for Progressive Taxation* (1953) 103, to be found also in 19 *U. of Chi. L. Rev.* 417 (1952). The authors sum up thus: "The case for progression, after a long critical look, thus turns out to be stubborn but uneasy. The most distinctive and technical arguments advanced in its behalf are the weakest. It is hard to gain much comfort from the special arguments, however intricate their formulations, constructed on notions of benefit, sacrifice, ability to pay, or economic stability. The case has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. But the case for more economic equality, when examined directly, is itself perplexing. And the perplexity is greatly magnified for those who in the quest for greater equality are unwilling to argue for radical changes in the fundamental institutions of the society."

19 Book review, 21 *U. of Chi. L. Rev.* 502, 503, 505 (1954).

20 Book review, 67 *Harv. L. Rev.* 725, 730 (1954).

than shaken my belief that there should be more, rather than less, progression in the American tax system."

In recent years, opponents of progression have centered their hopes on a movement, which has taken several forms, to amend the Constitution to limit the maximum rate for federal income taxation to 25 per cent. The movement has apparently drawn some strength recently from a widely-publicized essay by Colin Clark, the Australian economist, arguing that "the safe political and economic level of taxation is somewhere near 25 per cent of the national income" and that "beyond this point inflation may become uncontrollable." [21] Although this benchmark referred to the ratio of all types of taxes, national and state, to total national income, it seems to have gained unwarranted currency as a scientific validation of the proposal to limit federal income taxation to 25 per cent of the individual taxpayer's income.[22]

The original plan for combating federal income tax progression, which has been before the states since 1939,[23] was for petitions by the state legislatures for a constitutional convention, a method for proposing amendments that is authorized by Article V of the Constitution,[24] though never yet employed. Some twenty-nine states have adopted such resolutions; [25] only 32 are required by the Constitution. But in some states the resolution was vetoed by the governor or later rescinded by the state legislature, and the effect of such action is not clear. Also perplexing is the question whether all resolutions must be adopted within some limited period of time. (The first of the resolutions was adopted in 1939.) Some of the resolutions call for a maximum rate of income tax of 25 per cent, with no escape; others permit the limit to be raised by a vote of three-quarters of the members of both Houses of Congress, but only "in the event of a war in which the United States is engaged creating a grave national emergency requiring such action to avoid national disaster." Even in such a case, the action (requiring a consensus not needed for any other action by Congress, including the declaration of war) is effective for a one year period only, though by a similar vote the limit may be raised for successive periods of one year each. It is not clear whether the Korean "police action" would have been a "war" as that term is used in the proposed amendment, nor whether a declaration by Congress that a war had created the requisite emergency would be conclusive on the courts. Possibly, it would be open to a taxpayer, in the event the 25 per cent barrier was pierced by Congress, to show that such action was not required

[21] Clark, "The Danger Point in Taxes," *Harper's Magazine* (December, 1950) p. 67; Clark, "Public Finance and Changes in the Value of Money," 55 *Economic J.* 371 (1945); for criticisms, see Goode, "An Economic Limit on Taxes: Some Recent Discussions," 5 *Nat'l. Tax. J.* 227 (1952); Tax Institute, *The Limits of Taxable Capacity* (1953). Ironically, Clark's 25 per cent limit was foreshadowed in his pamphlet, *A Socialist Budget*, recommending policies for a Labor Government "for a period of transition to Socialism," published by the British New Fabian Research Bureau in 1935.

[22] Still another proposal is for a constitutional amendment to limit total federal taxes for all non-military expenditures to not more than 5 per cent of national income. H.J. Res. 252, 97 Cong. Rec. A4334 (1951).

[23] *Constitutional Limitation on Federal Income, Estate, and Gift Tax Rates* (Prepared for the Joint Committee on the Economic Report and the House Select Committee on Small Business), 82d Cong., 2d Sess. (1952).

[24] "The Congress, . . . on the Application of the Legislatures of two thirds of the several States, shall call a Convention for proposing Amendments. . . ."

[25] Packard, "The Need to Limit Federal Taxes," 32 *Taxes* 151, 154 (1954).

"to avoid national disaster" because Congress could either levy other types of taxes or borrow to finance the costs of the war. The limit may be lifted only while the nation is "actively engaged" in war, a qualification that would presumably prevent going above 25 percent in later years to pay veterans' benefits, to pay off a war-occurred debt, or even to pay the interest on war bonds.

The Constitution is silent on the powers of a constitutional convention, and it is possible that its authority would be unlimited. Partly because of the possibility that a convention would have the power to rewrite the Constitution (although its proposals would still be subject to ratification in the same manner as amendments proposed in the usual manner by Congress), and partly because of other uncertainties in the use of a convention, the tax limitation movement has lately turned to the more traditional way of amending the Constitution—by an amendment proposed by a two-thirds vote of both Houses of Congress and submitted for ratification to the states.

In 1951, the so-called first Reed-Dirksen Amendment was introduced, imposing the familiar 25 per cent limit as the maximum rate for federal income taxation. Like the state proposal, this amendment, which has been endorsed by the House of Delegates of the American Bar Association,[26] provides for a suspension of the limit by a vote of three-fourths of the membership of both Houses of Congress in time of war when necessary "to avoid national disaster." It also permits the limit to be raised, by a similar vote, to 40 per cent at any time, for one or more periods of one year each. This proposal has now been modified by the second Reed-Dirksen Amendment, which adheres to the 25 per cent limit, but allows Congress by a three-fourth vote to exceed the limit at any time, except that the top rate (if above 25 per cent) may never be more than 15 percentage points above the bottom rate. While enlarging the power of Congress to suspend the 25 per cent limit, the modified proposal would restrict the degree of progression even in wartime, by requiring the top and bottom rates to be separated by no more than 15 percentage points.[27]

It has been estimated that the 25 per cent limit on income taxation would have reduced federal revenues by $16 billion, using 1951 income levels as the basis of comparison. Corporate income tax liabilities would have accounted for $14 billion of this revenue loss and individual income tax liabilities for $2 billion. If this loss was not made up by a reduction in expenditures (Table I shows the composition of expenditures in 1951) or by federal borrowing, some additional tax or taxes would have been necessary, and the most likely would be a federal sales tax. It has been estimated that a tax of 10 percent on all retail sales, or of 15 per cent on all retail sales except food, would have been necessary to fill the gap. If the 25 per cent ceiling were lifted, the revenue loss would of course be lower. Assuming the 40 per cent authorized by the first Reed-Dirksen Amendment, one supporter of the limitation movement estimates a revenue reduction in the neighborhood of $9 billion for the fiscal year 1951; as

[26] The report of the A.B.A.'s Special Committee on the amendment may be found in 98 Cong. Rec. A4366 (1952).

[27] But apparently exemptions can be granted, without thereby making the bottom rate 0 per cent. Thus, it would be possible for Congress (by a three-quarters vote) to enact an income tax with an exemption for the taxpayer, his spouse, and his dependents of $2,500 each, with a tax rate of 75 per cent for the first $25,000 above the exemption and of 90 per cent for all amounts thereafter.

to the revised Reed-Dirksen amendment (allowing the 25 per cent limit to be suspended, so long as the maximum rate is within 15 percentage points of the bottom rate), he estimates that if individual rates were graduated from 22 per cent (the present bottom rate) to 37 per cent (*i.e.*, 15 per cent above the minimum rate) and if corporate rates ranged from 30 per cent (the present bottom rate) to 45 per cent, the yield of the individual and corporate income taxes would be reduced by about $5 billion.[28] He estimates that these losses could be made up by a federal retail sales tax of 8 per cent or 4 per cent respectively, and argues that even this course would be unnecessary in time because the stimulating effect of the reduction in income taxes would eventually give us a higher yield than the old rates.[29] The criticism of progression, like the attack on other aspects of the federal income tax, must always eventually come to grips with the problem of alternative sources of federal revenue, unless either deficit spending is to be employed or the level of expenditures is drastically cut. Any tax that is levied as a substitute for the federal income tax will have its own effect on incentives, spending, investment, and the price level; and in predicting these effects, it is necessary to make assumptions about the shifting and incidence of any such alternative tax. Moreover, one must also contend with the taxpayer's sense of fairness: would an abandonment of the progressive principle in the income tax arouse animosity to any other tax that might be imposed in its place, and frustrate its administration? The student who wishes to pursue these problems further will find suggestions in the Selected Bibliography at the end of this introduction.

A Hop, Skip, and a Jump through Federal Tax Procedure [30]

When income tax rates began to soar at the beginning of World War II, it became evident that the old method of waiting until March 15th [31] of each year to collect the tax on the income of the preceding year called for a degree of thrift that many taxpayers lacked and would guarantee a large volume of uncollectible tax liabilities. To meet this problem, Congress enacted the Current Tax Payment Act of 1943, putting wage and salary earners on a withholding basis of tax collections. This system, which has been in effect ever since, covers all wage and salary payments by an employer to an employee, except payments

[28] The Reed-Dirksen Amendment, in both forms, would also eliminate the federal estate and gift taxes, which have produced from $500 to $900 million annually for the last ten years.

[29] The course of a running debate on the tax limitation movement may be followed in these articles: Griswold, "Can We Limit Taxes to 25 per cent?" 190 *Atlantic Monthly* 76 (1952); Dresser, "The Case for the Income Tax Amendment: A Reply to Dean Griswold," 39 *A.B.A.J.* 25 (1953); Dresser, "The Reed-Dirksen Amendment: Developments in the 83d Congress," *id.* at 206; Cary, "The Income Tax Amendment: A Strait Jacket for Sound Fiscal Policy," *id.* at 885. Dresser, "The Reed-Dirksen Amendment: A Reply to Professor Cary," 40 *id.* at 35 (1954).

[30] Parts of this subject will be examined in detail in Chapter 9; the discussion at this point is in general terms, without any attempt to state the rules or qualifications for special groups of taxpayers, like farmers, aliens, foreign corporations, taxpayers engaged in foreign trade, insurance companies, co-operative organizations, non-profit institutions, *etc.*

[31] The filing date for individual taxpayers on a calendar year basis was extended to April 15th by the 1954 Code. Corporate returns, however, are due on March 15th in the case of calendar year taxpayers. Most non-business taxpayers and many business taxpayers file on the calendar year basis, but a fiscal year may be elected instead, in which event an individual return is due 3½ months, and a corporate return 2½ months, after the fiscal year ends.

to agricultural and domestic workers and a few other groups. The employee informs his employer of the number of exemptions to which he is entitled, and the employer then computes, either by a formula or by reference to tables prescribed by statute, the amount to be withheld at each pay period from the employee's wages. The employer periodically pays the withheld amounts to the Treasury, and at the end of the year he prepares a Withholding Tax Statement (Form W-2) for each employee. One copy of this form is sent to the Treasury, where it serves as an information return to insure compliance by the employee. Another copy is attached by the employee to his tax return, which he files on April 15th of the following year. The amount withheld is credited on his actual liability, and he either pays the balance due or receives a refund if there was an overpayment. If the employee is in the lower tax brackets, the amount withheld will correspond closely, and perhaps exactly, to the tax due, unless he worked irregularly, had outside income, or had deductions exceeding the standard amount assumed by the withholding tables. (An employee who anticipates a tax liability in excess of the amount that would normally be withheld may authorize his employer to withhold additional amounts.) In the fiscal year 1953, approximately $21 billion of the $32.5 billion of individual income taxes collected was withheld by employers.

Although the withholding system keeps many taxpayers on a current basis, requiring only minor year-end adjustments between the amount withheld and the actual tax liability, there are many gaps in its coverage. Being restricted to wage payments, it does not cover the income of self-employed persons, members of partnerships, or income from investments; and for upper-bracket employees the amounts withheld may be only a small down payment on the actual liability.

But the withholding system is buttressed by a requirement that certain taxpayers file declarations of "estimated tax" on April 15 of each year (or on a corresponding date if a fiscal year is employed), estimating their tax liability for the current year and the amount to be withheld from their wages. Any balance due must be paid in four installments, the first on April 15th (when the declaration is filed) and the others on June 15th, September 15th, and the following January 15th. Such declarations of estimated tax must be filed by any individual expecting $5,000 or more of gross income, except married persons and "heads of households," for whom the limit is $10,000. In addition, an individual whose gross income is expected to be below these limits must file a declaration if he expects to receive more than $100 of income not subject to withholding and if his gross income from all sources is expected to exceed his exemptions by more than $400. When the tax return itself is prepared on or before April 15th of the following year, payments of estimated tax, like taxes withheld from wages, are credited against the actual tax liability reported on the return, and any balance is either paid by or refunded to the taxpayer, as the case may be.

An individual income tax return must be filed by any one with gross income of $600 or more for the taxable year, unless he is 65 or older, in which case the limit is $1,200.[32] A taxpayer whose gross income falls below the limit could have no tax liability, but if any amounts were withheld from his wages or paid on a declaration of estimated tax, he would file a return in order to get a refund.

[32] A person aged 65 or more is entitled to two exemptions of $600 each, so that no tax could be due unless gross income exceeded $1200.

The return itself may take one of three forms. The simplest is Form 1040A, the Employee's Optional return, which may be used by a taxpayer with gross income of less than $5,000 provided (a) he had no income other than wages, dividends, and interest, and (b) he did not have more than $100 of gross income not subject to withholding. Form 1040A calls for a statement of the taxpayer's exemptions, his employer's name and address, his wages and other income, and the amount of income tax withheld. The return, with Form W-2 attached, is sent to the District Director of Internal Revenue, who computes the tax due from the statutory tables, and either bills the taxpayer for any additional amount due or refunds any overpayment. This is a mechanical process, not foreclosing the possibility of an audit of the return and a correction of any errors in it at a later date.

Form 1040 is more elaborate. It calls for a statement of the taxpayer's exemptions, for detailed information about his income from all sources (wages, salaries, dividends, interest, rents and royalties, *etc.*), and for an itemization of his business and personal deductions. (In lieu of itemizing personal deductions such as charitable contributions, interest, taxes, and extraordinary medical expenses, the taxpayer may take an "optional standard deduction," as will be seen in Section B(5) of Chapter 3.) If the taxpayer was engaged in a business or profession, he segregates the income and deductions attributable to this activity and reports them on a separate Schedule C, carrying the net profit or loss from Schedule C to a summary schedule on Form 1040 itself. Similarly, if the taxpayer sold or exchanged any property, he reports such transactions on Schedule D, and carries a summary of the profit or loss on such transactions from Schedule D to Form 1040. Another schedule is employed by farmers (Form 1040F), the net profit or loss being likewise carried over from this schedule to the body of Form 1040. From this information, the taxpayer computes his tax, credits himself with any taxes withheld from his wages and with any amounts paid on his declaration of estimated tax, and pays the balance due or, if there was an overpayment, informs the Treasury whether he wishes the overpayment refunded to him or credited on his declaration of estimated tax for the current year.

Form 1040 calls for three pages of information, not including any schedules or further explanations that may accompany it, and when prepared in full is known as "Form 1040—Long Form." Taxpayers with "adjusted gross income" [33] of less than $5,000 may omit part of Form 1040, employing it in a "Short Form." Such a taxpayer reports his gross income and business deductions as required by Form 1040, but instead of itemizing his personal deductions and calculating the tax due by reference to the schedule of tax rates, he turns to the tax table on page 4 of Form 1040 and finds his tax liability without any arithmetical calculation. The table allows about 10 per cent of the adjusted gross income for personal deductions; if the taxpayer's actual personal expenses exceed this amount, it will be to his advantage to itemize them and calculate his tax on the Long Form. The Short Form may be disadvantageous in another respect: the table of tax liability lumps together incomes by $25 or $50 "steps," and imposes a uniform tax on all incomes within each step. Thus, single taxpayers having one exemption must pay $724 on incomes between $4,500 and $4,550. A tax-

[33] This term is defined by § 62 of the Code (see also Chapter 3, Sec. B(5); roughly speaking, it means gross income less business expenses.

payer using the Long Form and claiming the 10 per cent optional standard deduction would pay $728.70 on an income of $4549, but only $719 on an income of $4500. This discrepancy results from the fact that the Short Form table bases the tax liability on the mid-point of the "step," *i.e.*, in the example given, on $4,525 of income. Taxpayers above the midpoint may save a few dollars by using the Short Form; taxpayers below it may save by using the Long Form.

Just as the Long Form may sometimes be preferable to the Short Form, it may also be preferable to Form 1040A, the Employee's Optional return. This will be true, for example, if the employee has personal deductions in excess of the standard 10 per cent allowed by the table, or if the taxpayer's income falls below the mid-point on which the tax for his "step" is based.

Use of either the Short Form or the Employee's Optional return also entails a loss of certain credits.

Before the enactment of the 1954 Code, corporations were not required to file declarations of estimated tax. Moreover, until 1950, the corporate tax liability was payable in equal quarterly installments after the end of the taxable year; in the past few years, however, the delay in payment has been gradually reduced, so that a corporation on the calendar year basis must pay the tax on its 1954 income in equal installments on March 15 and June 15, 1955. The 1954 Code accelerates payment of some corporate tax liabilities still further. It requires any corporation expecting an income tax liability in excess of $100,000 in 1955 to file a declaration of estimated tax on September 15, 1955 (if a calendar year basis is employed), and to pay the estimated tax in installments on September 15 and December 15, 1955, and March 15 and June 15, 1956. To ease the transition, in the first year of the accelerated system, the installments will be in the ratio 5-5-45-45 per cent; but the first two installments will increase each year of the new system's operation, until by the taxable year 1959, the tax will be payable in four equal installments. (The last two installments may vary in amount, however, if the actual tax liability proves to be different from the tax as estimated on the declaration.) Corporations with an expected income tax liability of $100,000 or less are not required to file declarations; such corporations may continue to pay the tax in two equal installments, the first on March 15th following the taxable year (if a calendar year basis is used) and the second on June 15th. It is estimated that about 20,000 of a total of about 425,000 corporations will be required to file declarations of estimated tax; this group, however, pays about 85 per cent of the total corporate tax liability.

The corporate income tax return is Form 1120. Provision is made on the return for reconciling differences between the treatment of financial items for tax purposes and their treatment on the regular books of the corporation. Special forms are prescribed for certain categories of corporations, such as life insurance companies, non-resident foreign corporations, and others. While an individual is required to file a return only if his gross income is $600 or more, a corporation must file a return without regard to the amount of its gross income or even if the year's operations produced a loss.

Fiduciaries must also file tax returns. A fiduciary who is in charge of an individual's income (*e.g.*, the guardian of a minor or the committee of an incompetent) must file Form 1040 or Form 1040A for the person in his charge, and an executor or administrator must also file Form 1040 or 1040A for the in-

come of a decedent to the date of his death. In addition, Form 1041 (Fiduciary Return) must be filed by a fiduciary for an estate if its gross income for the taxable year is $600 or more and for a trust if its gross income is $600 or more or if it has any taxable income. The fiduciary deducts any amounts distributable to beneficiaries; these amounts are taxable to the beneficiaries, to be reported on their respective individual returns, and the fiduciary pays a tax only on the balance.

The partnership return requires a special word. A partnership reports its income and deductions on Form 1065 in about the same way that a corporation reports on Form 1120 and an individual engaged in business reports on Schedule C of Form 1040. But the partnership is not a taxable entity. After calculating its profit or loss for the taxable year, the firm reports, on a schedule at the end of Form 1065, how this amount is allocated among the partners by the partnership agreement. No tax is calculated, however, since each partner's share of the firm's profit or loss is reported by him on his individual tax return, Form 1040. The partnership return, then, is an information return, explaining how the individual partner's share of the firm's profit or loss has been computed.

Many other information returns are also filed with the Treasury. Form W-2, informing the government of an employee's gross wages and of the amount of the tax withheld by the employer, has already been mentioned. Any one who pays an employee, in the course of trade or business, $600 or more of wages, salaries, or other compensation not subject to withholding must file Form 1099, and a similar report is required for payments in the course of trade or business of $600 or more (a) of fees to attorneys, accountants, physicians, and other professional persons, and (b) of rent, royalties, annuities, or other fixed or determinable income. Before the 1954 Code, such payments were supposed to be reported even though not made in the course of trade or business, but apparently the requirement was widely disregarded; the House of Representatives proposed to eliminate the requirement altogether, but the Senate restored it, restricted to payments in the course of trade or business. Certain payments of interest and dividends must also be reported; and information returns are also prescribed for a number of other specialized items, transactions, and persons.

The procedure that is set in motion by the filing of a tax return is examined in some detail in Chapter 9. The return is inspected for mathematical accuracy,[34] and examiners select for audit those returns that most merit further inspection. Their selection is based on the amount and nature of the income and deductions, errors apparent on the face of the return, random sampling techniques, and other factors. The examiners are assisted by the data on information returns, by the taxpayer's own returns for earlier years, by the deductions claimed by other taxpayers, by newspaper accounts of unusual or large-scale financial operations, and by tips from informers. The examiner may also resort to a subpoena, if necessary, to examine the taxpayer and others who may have knowledge of his financial affairs. About 2.5 million individual income tax returns were examined in the fiscal year 1953.

When an examiner's audit discloses an error in tax liability, he advises the

[34] In 1953, about 1.7 million out of 52 million individual returns were corrected for mathematical errors, resulting in tax increases of about $98 million and tax decreases of about $27 million.

taxpayer of his finding and attempts to settle the matter by agreement. If an agreement is not reached with the examiner, the taxpayer may have an informal conference with the examiner's group chief, and if no agreement is reached at this point, the taxpayer may have a more formal conference with an appellate staff that is administratively disconnected from the examiner and his chief. Most disputes are settled at the administrative level.

Should no agreement be reached, however, the taxpayer may "go to law." He may refuse to pay an alleged deficiency and file a petition in the Tax Court of the United States (formerly the Board of Tax Appeals), in which event the tax cannot be collected by the Treasury until the case is decided.[35] Instead of filing a petition in the Tax Court, the taxpayer may if he chooses pay the alleged deficiency and sue for a refund, with interest, in a federal District Court or in the Court of Claims. The advantages and drawbacks of the refund route as compared with the Tax Court are taken up in Chapter 9. If the dispute involves not a deficiency but a refund (*e.g.*, if after filing a return and paying the reported tax liability, the taxpayer finds that he reported too much income or failed to claim a deduction or credit to which he was entitled), and if the matter cannot be settled at the administrative level, the taxpayer may not go to the Tax Court, whose jurisdiction is restricted to deficiency cases, but must instead sue in the District Court or Court of Claims.

Cases in the Tax Court and in the District Courts go by appeal to the Courts of Appeals and thence by certiorari to the Supreme Court; cases in the Court of Claims may be reviewed only by the Supreme Court on certiorari.

The Sources of Federal Tax Law in a Nutshell

Taxes are imposed only by statute, and while the lawyer will often err if he does not go beyond the statute in passing on a tax question, the statute should almost always be his starting point. Moreover, this is not a field where the statute is encrusted with the wisdom or folly of the centuries, like the Statute of Frauds, nor is it one where the statute's principal function is to declare or to qualify the common law, like the Uniform Partnership Act or the Negotiable Instruments Law. Seldom in the law is it so essential that the lawyer study his statute intensively; sometimes the judicial decisions are mere embellishments of the handiwork of Congress. At the same time, some areas of tax law, especially where statutory pronouncements were absent, vague, or confused, have been immensely influenced by judicial doctrines of a common law character, created, that is to say, by the courts as case after case came before them,—and in these areas the lawyer must be attuned to the judiciary's signals even more than to those of Congress. Moreover, the very detail of the statute is often deceptively clear, since, as the student will find, the courts may exercise their traditional power to disregard form for substance, and to hold that an arrangement that complies with the literal terms of the statute is not within its spirit, just as a deed absolute on its face may be shown to be a mortgage. One of the fascina-

[35] If the Commissioner determines that ultimate collection of the tax would be jeopardized by delay, however, he may levy a jeopardy assessment and seize the taxpayer's property. This drastic procedure is often employed in cases involving fraud, or where it is feared that the taxpayer may dissipate or secrete his property. The government may not ordinarily sell the seized property, however, as a result of a 1954 amendment. See Chapter 9, Sec. B(2).

tions of federal law is the interplay between the detail of a statute and the creative spirit of the courts; and even the tax attorney who cannot pause to enjoy this interplay must understand it to survive.

The "statute" is of course the Internal Revenue Code of 1954, now bright as a penny. In recommending its enactment, the House Committee on Ways and Means said:

> Your committee has undertaken the first comprehensive revision of the internal-revenue laws since before the turn of the century and the enactment of the income tax. This revision includes a rearrangement of the provisions to place them in more logical sequence, the deletion of obsolete material, and an attempt to express the internal-revenue laws in a more understandable manner. . . .
>
> In addition, to the rearrangement, however, your committee has made many substantive changes in the code.[36]

It is apparent that, while the pre-1954 statute may not rule us from the grave, meditation on its meaning will be profitable, or at least necessary, for some time to come.

The "old" Internal Revenue Code, which was supplanted by the 1954 Code, was enacted in 1939, and was frequently amended in the years 1939-1954. Before 1939, federal income taxes were levied by biennial Revenue Acts, passed by each Congress for a two year period only. In point of fact, however, there was so much continuity of statutory language from one Revenue Act to another that permanent legislation in the form of an Internal Revenue Code represented no real break with the past. Before the 1939 Code was enacted, however, there existed the pleasant possibility that on the expiration of one Revenue Act Congress might be unable to agree on another. With a Code, we are assured that should Congress fail to act on a tax bill, the old tax rates will continue to control until changed. There is also a legal distinction, in that prior to 1939, the re-enactment of a taxing provision by Congress sometimes carried an implication that a construction of that provision by the courts or by the Treasury was approved. After the 1939 Code was adopted, Congress from time to time altered those sections of the Code that it wished to change, but there was no reason (except when the 1954 Code was adopted) to re-enact satisfactory sections, and hence no occasion for judicial application of the re-enactment rule. While Congressional inaction in the face of an administrative or judicial construction of a statute sometimes leads to the inference that Congress has adopted that interpretation, especially if *other* sections of the same statute have been amended in the meantime, this theory (that silence gives consent) has been applied more sparingly than the re-enactment rule. It remains to be seen whether the 1954 Code, where it re-enacts pre-1954 provisions, will be held to blanket in the administrative and judicial construction of these provisions. The 1939 Code was merely a codification of existing law, intended to draw together in one place a mass of statutes scattered throughout the many volumes of the *Statutes At Large*, and consequently would not support an inference of Congressional approval of existing interpretations. But the 1954 Code is a "comprehensive revision," and when an existing provision of law is accepted and re-enacted by it, there is a basis for assuming that no fault was found with the decisions or regulations construing that provision.

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[36] H. Rept. No. 1337, 83d Cong., 2d Sess., p. 1 (1954); the Senate Finance Committee's report, S. Rept. No. 1622 (1954), is identical on this point.

Although the Congressional debates ordinarily do not illuminate technical problems of federal taxation, since they are usually concerned primarily with the tax's rates and expected yield, there are occasional exceptions, and then recourse to the Congressional Record is necessary. The Committee Reports, on the other hand, are frequently helpful,[37] and it is common for the courts to rely heavily on them.[38] They are carefully prepared by technicians on the staff of the Joint Committee on Internal Revenue Taxation (composed of representatives of the House Ways and Means Committee and the Senate Finance Committee, who are assisted by a kind of legislative civil service of tax experts), but the profusion of technical detail in them makes it clear that they evidence the "intent" of Congress only if we apply the doctrine of *respondeat superior*.[39] Some members of th committee may know little of the content of the committee's reports, and this is *a fortiori* true of the members of Congress who do not serve on the tax committees, though no doubt some of them know no more about the statute itself.

Occasionally, though far more rarely, the courts refer to the hearings before the House and Senate Committees as an aid to construction. Although much of the oral testimony is often quite diffuse, interested public and private individuals and groups usually present closely reasoned memoranda in support of their positions. If a proposal is accepted, modified, or rejected by the committee after it has been explained by testimony or memorandum, the presentation may be a clue to the meaning of the committee's action and, by extension, to the meaning of the action of Congress. The hearings are printed by the committees in limited quantities, and are to be found in only a few libraries.[40]

Second only to the statute and the legislative "materials" in importance are the Treasury Regulations. Section 7805 of the 1954 Code authorizes the Secretary of the Treasury or his delegate to prescribe "all needful rules and regula-

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37 Since 1939, the reports of the House Committee on Ways and Means, the Senate Finance Committee, and the conference committees have been reprinted in the Internal Revenue Bulletin, which is published weekly (formerly biweekly) by the Internal Revenue Service. Every six months a compilation of these bulletins is issued; the compilation for the second half of 1953 is cited: 1953-2 Cumulative Bulletin, 53-2 C.B., or 53-2 I.R.B. The Congressional reports for the period 1913-1939 were reprinted together in a separate number of the Bulletin: 39-1 (Part 2) C.B.

38 On the use of such legislative "material" as an aid to the construction of statutes, see Lenhoff, *Comments, Cases and Other Materials on Legislation* (1949) 787-796, 814-816.

39 The preparation of the committee report is described as follows in Blough, *The Federal Taxing Process* (1952) 75-76:

> Preparation of the Committee report is ordinarily in the hands of the Chief of Staff of the Joint Committee [on Internal Revenue Taxation] and his staff members. The report is customarily divided into two parts. The first is a discussion in non-technical language of the need for the legislation, what the bill provides, and the anticipated impact on various groups of taxpayers. Among the tax staffs this section of the report is referred to as the "guff". Despite this derisive label, the section is very important. The latter part of the Committee report is a technical explanation of what each section of the bill provides. The Legislative Counsel [of the Treasury] and the Treasury tax staff participate in the preparation of the technical section. This part of the report is coming to be known as the "paraphrase"; it consists largely of a paraphrase of each section of the bill with examples showing how the provision presumably would apply in given situations. The Committee members usually listen to a reading of the "guff" before the report is submitted but ordinarily do not go over the "paraphrase," at least not in Committee.

40 On use by the judiciary of inaccessible legislative history as an aid to the construction of statutes, see Mr. Justice Jackson, concurring, in United States v. Public Utilities Commission, 345 U.S. 295, 319 (1953).

tions for the enforcement" of the Code. Identical authority was vested in the Secretary by earlier law. In addition, the Secretary is authorized to prescribe regulations to cover more specific areas, *e.g.*, by Section 170 of the 1954 Code he may lay down the method of verifying charitable contributions, by Section 453 he may prescribe how income from certain installment sales is to be reported, and by Section 472 he is authorized to issue regulations governing use of the last-in-first-out method of accounting for inventories. Regulations issued under these sections are of a quasi-legislative character; Congress has chosen to delegate to the Treasury authority it might have exercised itself. Other regulations interpret the statute for the guidance of the taxpayers and the staff of the Internal Revenue Service. Whatever their function, regulations are issued from time to time in the form of Treasury Decisions ("T.D."), which are compiled at irregular intervals as a systematic series of regulations. The last such compilations before the 1954 Code were known as "Regulations 118" (income tax), "Regulations 105" (estate tax), and "Regulations 108" (gift tax). There were other series for more specialized subjects. Changes in such a set of Regulations are issued as Treasury Decisions, and when the changes have accumulated in quantity, a new compilation of regulations is issued. Thus Regulations 118 was issued in 1953 to supplant Regulations 111, which had been frequently amended by Treasury Decisions since its issuance in 1943. The Administrative Procedure Act, 5 U.S.C. 1003, provides that proposed regulations (with certain exceptions) must be published in the Federal Register to permit interested parties to file their objections or suggestions for consideration before adoption. The Internal Revenue Service is now (August, 1954) in the process of completely revising the Regulations to accord with the clerical and substantive changes wrought by the 1954 Code.

Regulations, whether of a legislative or an interpretive character, can serve a useful function only if both administrators and taxpayers can rely on them. Seldom are regulations, of either kind, overturned by the courts, but occasionally a regulation, especially the interpretive type, is invalidated. It is impossible to generalize beyond saying that a regulation that was issued soon after the statute it interprets and that has been adhered to consistently by the government will command great respect from the courts, but that if contemporaneity and consistency are lacking, the courts will be less constrained to accept the regulation. As already mentioned, re-enactment of a statute may carry an implication of Congressional approval of an interpretive regulation,[41] and this doctrine may give the effect of law to some regulations that were in force when the 1954 Code was enacted. Since this was a comprehensive revision, the re-enactment doctrine may now be applied with greater fidelity to the facts of legislative life than for earlier years when revenue acts often carried over much of the language of earlier acts in the interest of simplicity rather than because administrative interpretations were endorsed. Another problem in this area is whether a proper interpretive regulation, either with or without re-enactment of the underlying statute, in time takes on the force of law so that only Congress, and not the Treasury, may alter it. Partly because the Treasury seldom

[41] It is hard to assess the importance of the re-enactment rule in this area. It may be only a handkerchief covering something already covered by a blanket if the court would have upheld the regulation, whether the statute had been re-enacted or not; but it may be crucial if the court thinks the regulation when issued was either debatable or demonstrably wrong.

amends interpretive regulations except to bring them into harmony with subsequent judicial decisions or new statutes, there is little authority on this subject. Despite earlier doubts, apparently the Treasury may ordinarily amend an interpretive regulation if the new interpretation is to be given prospective force only, and there may also be power to apply it retroactively. Retroactive application may be withheld by the Treasury itself, however, as wise administration, pursuant to its power, now conferred by Section 7805(b) of the 1954 Code, to prescribe the extent to which regulations and rulings shall be applied prospectively only.[42]

In addition to the Regulations, which are issued by authority of the Secretary of the Treasury, a steady supply of rulings, instructions, releases, and other lesser pronouncements flows from the Internal Revenue Service. Not bearing the imprimatur of the Secretary, these documents are less authoritative than the Regulations, but they are of great importance in the day-to-day administration of the tax laws, and often they are persuasive to the courts. The most important are letters to taxpayers in response to requests for rulings on past or contemplated transactions and instructions of a more general nature to field offices of the Service. Some rulings are no more than a curt "yes" or "no" to an inquiry; others are more or less elaborately argued interpretations of the statute, regulations, and judicial decisions. The designation "Revenue Ruling" is now employed for substantially all such announcements; previously they were issued under various labels, of which the most important were "I.T." (rulings to taxpayers on income tax matters), "G.C.M." (General Counsel Memorandum, usually discussions of legal problems of general interest), and "Mim." (Mimeograph, usually instructions to field offices). Revenue Rulings are published in the Internal Revenue Bulletin; not all are chosen for this distinction, however, and the criteria now governing publication are outlined in Rev. Rul. 2, quoted in Section A, Chapter 9. Chapter 9 also contains material on the status and effect of rulings.

Tax litigation commences in the Tax Court of the United States (formerly the Board of Tax Appeals), in the various federal District Courts, and in the Court of Claims. The opinions of the Tax Court fall into two categories: "regular" decisions, which are published by the court itself, and "memorandum" decisions, which are not officially reported but are published commercially by Prentice-Hall, Inc. and by Commerce Clearing House. The opinions of the District Courts, Court of Claims, Courts of Appeals, and Supreme Court are, of course, to be found in the regular federal reports, but the tax cases decided by these courts are also separately published by Prentice-Hall, Inc. in the series "American Federal Tax Cases" (cited as A.F.T.R.) and by Commerce Clearing House in the series "United States Tax Cases" (cited as U.S.T.C.). These sets also contain some opinions of the lower federal courts in tax cases that are not

[42] See Griswold, "A Summary of the Regulations Problem," 54 *Harv. L. Rev.* 398 (1941), which cites a number of other important articles in footnote 1; Feller, "Addendum to the Regulations Problem," *id* at 1311; Griswold, "Postcriptum," *id.* at 1323. Several important cases were decided after these articles were prepared. Helvering v. Reynolds, 313 U.S. 428 (1941); American Chicle Co. v. United States, 316 U S 450 (1942); Helvering v. Edison Bros. Stores, Inc., 133 F.2d 575, cert. denied, 319 U.S 752 (1943). See also Davis, *Administrative Law* (1951) 217-226; White, "The Scope of the Treasury's Power to Issue Nonretroactive Regulations," 38 *Calif. L. Rev.* 292 (1950); Eisenstein, "Some Iconoclastic Reflections on Tax Administration," 58 *Harv. L. Rev.* 477 (1945).

to be found in the Federal Supplement. A few opinions on federal tax claims are handed down by federal courts sitting in bankruptcy and by state courts passing on probate or receivership matters.

When the Internal Revenue Service loses a case in the Tax Court, the Commissioner ordinarily announces, in the Internal Revenue Bulletin, whether he "acquiesces" ("Acq." or "A") or does not acquiesce ("Non-Acq." or "NA") in the decision. Acquiescence operates as advice to the staff of the Service to rely on the decision in the disposition of other cases. Non-acquiescence indicates that the Service, whether it appeals the decision or not, will not accept the principle enunciated in it in disposing of other cases (though of course it binds the government as to the taxpayer in the case itself, unless reversed on appeal), and that it may litigate the same issue when it arises again. Because decisions of the Tax Court are reviewed by eleven Courts of Appeals, the government may eventually succeed in obtaining a reversal of the Tax Court, even though in the non-acquiesced case its decision was affirmed by a Court of Appeals; and, indeed, the principal way for the Treasury to get a conflict among the circuits (as a basis for a petition for certiorari) when the Tax Court decides in favor of the taxpayer is to stick to its guns and relitigate the same issue in one or more other cases. After announcing its non-acquiescence, the Treasury may be discouraged by a series of losses in the Courts of Appeals, or it may reconsider its views for other reasons, and substitute an acquiescence for non-acquiescence.[43] Another administrative practice related to litigation is based on the Treasury's power, already mentioned, to prescribe the extent to which its rulings and regulations will be applied prospectively only. When a judicial decision in the government's favor overrules earlier cases or conflicts with rulings that had been extensively relied on by taxpayers, the Treasury sometimes announces that a new regulation or ruling, issued to conform to the judicial decision, will not be applied retroactively.[44]

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Statistics. *Statistics of Income*, published annually by the Treasury Department, is a compilation of information from tax returns. Additional information

[43] Dwan, "Administrative Review of Judicial Decisions: Treasury Practice," 46 *Col. L. Rev.* 581, 591-594 (1946).
[44] *Id.* at 596-598.

may be found in the *Annual Reports* of the Secretary of the Treasury and of the Commissioner of Internal Revenue, and in the *Statistical Abstract of the United States* and a supplement to it, *Historical Statistics of the United States.* An analytical study of recent statistics is Kuznets, *Shares of Upper Income Groups in Income and Savings* (1953).

Theory. General works on public finance that discuss the relation of income taxation to the economy are: Shultz and Harriss, *American Public Finance* (5th ed. 1949); Somers, *Public Finance and National Income* (1949); and Lutz, *Public Finance* (4th ed. 1947). Three useful symposiums on such problems are: Groves, *Viewpoints on Public Finance* (1947); Poole, *Fiscal Policies and the American Economy* (1951); and Millikan, *Income Stabilization for a Developing Democracy* (1953). Works that are concerned more exclusively with taxation are: Seligman, *Essays in Taxation* (10th ed. 1928); Simons, *Personal Income Taxation* (1938); Vickrey, *Agenda for Progressive Taxation* (1947); Blum and Kalven, *The Uneasy Case for Progressive Taxation* (1953); Rhys-Williams, *Taxation and Incentive* (1953); Kimmel, *Taxes and Economic Incentives* (1950); von Mering, *The Shifting and Incidence of Taxation* (1942). Other studies of the shifting and incidence of taxes are cited by Shultz and Harriss, *supra*, pp. 193–226.

Current problems. Some of the works cited above discuss issues of particular contemporary interest, as well as long run problems. Recent works with programs for overall reform of the federal tax structure are: Groves, *Postwar Taxation and Economic Progress* (1946); Simons, *Federal Tax Reform* (1950); Paul, *Taxation for Prosperity* (1947) (the recommendations are in Chapters 27–46; the earlier historical matter is supplemented by the author's 1954 book, cited above); Committee on Postwar Tax Policy, *A Tax Program for a Solvent America* (1945). The Tax Institute sponsors annual symposiums on subjects of current interest; some are referred to hereafter, but mention should also be made of: *Taxation and Business Concentration* (1950); *The Limits of Taxable Capacity* (1953); and *Excess Profits Taxation* (1953). Blough, *The Federal Taxing Process* (1952), is an excellent account of the way federal revenue laws are drafted, enacted, and administered. A number of more specialized works are cited throughout the casebook.

Empirical studies. A series of empirical studies, by questionnaire and interview, of the effects of federal taxation was recently conducted under the sponsorship of the Harvard Business School. Some are cited elsewhere in this book; see also Butters and Lintner, *Effect of Federal Taxes on Growing Enterprises* (1945); Hall, *Effects of Taxation: Executive Compensation and Retirement Plans* (1951); Smith, *Effects of Taxation on Corporate Financial Policy* (1952).

Legal works. Magill, *Taxable Income* (rev. ed. 1945), discusses the main problems in defining income. Stanley and Kilcullen, *The Federal Income Tax* (2d ed. 1951) is a brief summary of the most important provisions of pre-1954 law. Two admirable collections of essays (in separate pamphlets) covering the subject of federal income taxation fairly systematically are *Fundamentals of Federal Taxation* and *Current Problems in Federal Taxation.* Both series are published by the Practising Law Institute and will no doubt be revised to reflect the 1954 Code. Mertens, *Law of Federal Income Taxation* (2d ed. 1948), in 14 volumes, supple-

mented by pocket supplements, is a standard reference work. The student should also become familiar with the resources, and limitations, of the looseleaf services. The February, 1954, draft of a *Federal Income Tax Statute*, published in two volumes by the American Law Institute, may be profitably compared with the 1954 Code adopted by Congress. A number of specialized treatises, proceedings of tax institutes, and law journal articles are referred to at appropriate points in the editor's Notes hereafter.

Bibliography. There is a more complete bibliography in Blough, *The Federal Taxing Process* (1952) 481–494.

CHAPTER 1

INTRODUCTORY: SOME CHARACTERISTICS OF INCOME

The Sixteenth Amendment grants Congress the power "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Section 61(a) of the Internal Revenue Code of 1954 announces broadly that:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items. . . .

Section 22(a) of the 1939 Code was more elaborate

> "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

The committee reports on the 1954 Code state that while the language of § 22(a) has been simplified, the "all-inclusive nature of statutory gross income has not been affected thereby," and that it was "not intended to change the concept of income that obtains under § 22(a)." H. Rept. p. A18; S. Rept. p. 168.* This introductory chapter is an examination of the outer limits of § 61(a). We will leave for later study the various self-denying ordinances by which Congress has excluded from income certain items, or has allowed others to be deducted or credited. We are concerned here only with how far Congress might go if it chooses.

We shall see that the boundaries of the term "income" are hazy and shifting. Yet most transactions and items are either clearly within or clearly without its area. The bulk of our administrative rulings and judicial decisions is concerned with the issues that are met in later chapters of this book—issues which arise only where this chapter leaves off, so to speak. These more frequently litigated issues arise under provisions of the Internal Revenue Code that exclude from taxable income items that could clearly be taxed if Congress chose, that grant preferential treatment to certain kinds of income, and that allow various deductions, exemptions, and credits in computing the actual tax to be paid. Other areas of dispute are the determination of the proper year for reporting items that are admittedly income to the particular taxpayer in one year or another, and the determination of which

* H. Rept. No. 1337 and S Rept. No. 1622, 83d Cong., 2d sess. (1954). The conference committee's report is H. Rept. No. 2543.

of several taxpayers must report items that are undeniably income to one of them. Yet we cannot ignore, even though we less frequently encounter, the question which this chapter asks and seeks to answer: what are the characteristics of income?

The inquiry is a difficult one, and the author should confess at the outset that organizing this chapter has been troublesome. The Supreme Court, which at one time attempted to define "income" in a neat sentence, has recently announced:

> In fact, no single, conclusive criterion has yet been found to determine in all situations what is a sufficient gain to support the imposition of an income tax. No more can be said in general than that all relevant facts and circumstances must be considered. *Commissioner* v. *Wilcox,* 327 U.S. 404, 407 (1946).

The items or transactions that have forced the courts back to a consideration of fundamentals by requiring them to pass on the "outer limits" of the term "income"—thus providing the grist for this chapter—often seem to have little in common with each other. These items are, moreover, on the whole of minor importance to the generality of taxpayers, when they are not downright bizarre.

Furthermore, despite the fact that we have several times been advised that Congress intended "to use the full measure of its taxing power" in promulgating § 22(a) of the 1939 Code, *Helvering* v. *Clifford,* 309 U.S. 331, 334 (1940), it is not always clear whether courts in holding that this or that item does not represent "income" were excluding it on constitutional grounds or on the theory that it was not within the intended scope of § 22(a). As indicated above, § 61(a) of the 1954 Code is intended to have the same meaning as § 22(a) of the 1939 Code. This would suggest that it does not change the treatment of the items dealt with in this chapter, whether they were believed by the courts to be exempt from taxation on constitutional grounds or only because not within the statutory grasp of § 22(a). But the House Report on the 1954 Code states that the term "income" in § 61(a) is used "in its constitutional sense," and, as will be seen, there are some instances where it has been thought that § 22(a)'s use of the term "income" was not so broad. To add to our difficulty, the Senate Report says that in § 61(a) "the word 'income' is used *as in section 22(a)* in its constitutional sense." S. Rept. p. 168 (italics added).

The waters are muddied still further by the fact that the Sixteenth Amendment is not the only source of Congressional authority to tax. Article 1, Section 8, Clause 1 of the Constitution provides:

> The Congress shall have Power to Lay and Collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts, and Excises shall be uniform throughout the United States.

Direct taxes must by virtue of Article 1, Sections 2 and 9, be apportioned among the states according to population (a requirement that makes them totally impracticable), and to the extent that an income tax is a direct tax, recourse must be had to the Sixteenth Amendment for relief from this requirement of apportionment. But to the extent that a tax on income or on anything else is *not* a direct tax, Congress does not have to rely on the Sixteenth Amendment.

Even though a particular item is not "income" as the term is used in the Sixteenth Amendment, then, it is not necessarily placed beyond the reach of Congress. An indirect tax on the item is authorized by Article 1, Section 8, Clause 1. But we then are face to face with a dilemma. For if the item is not "income," can Congress

have intended to tax it under an income tax law? Would Congress have desired to add together "income" and other appropriate objects of taxation and levy a single graduated tax on the total? The student will find that the last two questions are hardly acknowledged, let alone answered, by the cases that follow. It has generally been assumed that if an item is not "income," Congress did not intend to tax it under the income tax sections of the Internal Revenue Code.

SELIGMAN
INCOME TAX

IN ENCYCLOPEDIA OF THE SOCIAL SCIENCES

New York: The Macmillan Co., 1932, Vol. 7, pp. 628–9, 630–1

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The Concept of Taxable Income. As an economic concept income denotes a flow of wealth during a definite period, as opposed to capital as a fund of wealth at a distinct point of time. It may be defined as the money or money's worth which comes in during a definite period over and above the expenses of acquisition. The fiscal concept of income, however, is still subject to dispute. In the nineteenth century Hermann and Schmoller elaborated the free disposition or consumption concept, which regards as income only those receipts of which an individual can dispose without impairing his capital. More common outside Germany was the periodicity concept, which would limit income to regularly recurring receipts. The broadest definition of income for taxation purposes was formulated by Georg Schanz in 1894 and was independently advanced over two decades later by R. M. Haig, who defines income as "the money value of the net accretion to one's economic power between two points of time." This view is in substantial agreement with the accountant's practice of ascertaining the annual profit of an enterprise by comparing the balance sheet at the opening and the close of the year. As a reaction to Schanz, Strutz and Fuisting developed the source concept (Quellentheorie), which would confine taxable income to receipts from permanent sources.

With the exception of the income taxes in Basel and in Bremen, where the broader concept was almost wholly accepted, fiscal practice at the outset inclined toward the narrower interpretation of income. In the course of time, however, the concept was widened, the characteristic of regularity disappeared, while chance or aleatory receipts were subjected to supplementary taxes. At the present time findings, occasional earnings or lottery prizes are everywhere included in income, while inheritances are separately taxed, in part because they constitute irregular or accidental income. Special taxation of gifts is also widespread but is sometimes frustrated by administrative difficulties, as in the American experiment of 1922.* Neither the permanence of the source nor the regularity of the receipt any longer forms a necessary part of the concept of taxable income.

The widening of the income concept, however, brought forth a number of difficult problems. . . .

Another disputed point is the problem of including savings in taxable income. John Stuart Mill claimed that to include savings in income is to impose double

* A federal gift tax was imposed by the Revenue Act of 1924 (not 1922), but it was repealed by the 1926 Act. It was reimposed in 1932, however, and is still in effect. [Ed.]

taxation—a tax first on the entire income and then again on the yield of the income that has been transmuted into capital. This contention, which has been renewed in recent years by Einaudi and others, suffers from several defects. First, it rests on a confusion between the receipt and the disposition of income. Income may be either spent or saved, but both these actions are subsequent, not anterior, to the receipt. One must have the income before he decides what to do with it. The concept of income is independent of the use to which it is put. Secondly, the double tax argument is a fallacy. In the first year a tax is imposed on the entire income from whatever source derived; in the second year there is similarly imposed a new tax, which is now increased because of the additional income. This is not taxing the same thing twice, it is levying taxes on different things; namely the successive and therefore different incomes. If the individual prefers to save rather than to spend his income, his preference is evidently due to the anticipated advantages of his action. But these clearly augment his ability to pay. To refrain from taxing the proceeds of the capital into which the income of the previous year has been transmuted would involve the abandonment not of a double tax, but of a single tax. Thirdly, if savings are not taxed as income then the income tax is transformed into a tax on expenditure, which is the least defensible of all the criteria of ability to pay. While a poor man indeed spends less than a rich man, the disparity in outlay bears no proportion to the disparity in wealth. The richer a man is, the more difficult it is to spend his income and the more automatic his savings become. To tax both Henry Ford and his seven dollar a day employee on their expenditures would be a travesty of justice: the latter has to spend virtually his entire earnings; the former, even with the best of will, can spend only a fraction of his profits. For these reasons no country has ever seriously entertained the idea of excluding savings from taxable income. The exemption of insurance premiums and the isolated instances of the exemption of certain types of saving deposits may be defended on quite different grounds.

Quite an opposite suggestion was advanced by J. A. Hobson, urging that only so much of income should be deemed taxable as constitutes a true surplus. By surplus Hobson means "all rents and all gains for the use of capital, brains or labor which are not a necessary incentive to secure such use." But the essential vagueness of this concept and the almost insuperable difficulties of application, coupled with the well nigh practical identity of the results with those of the existing system of graduated income tax and exemptions, have combined to prevent any hearing for the suggestion.

SURREY AND WARREN
THE INCOME TAX PROJECT OF THE AMERICAN LAW INSTITUTE. GROSS INCOME, DEDUCTIONS, ACCOUNTING, GAINS AND LOSSES, CANCELLATION OF INDEBTEDNESS

66 Harv. L. Rev. 761, 769–71, 775 (1953)

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The American Law Institute through its Tax Project is undertaking a complete examination of the technical provisions of the federal income, estate, and gift tax laws. Commenced in 1948 as an Income Tax Project, the undertaking was enlarged in the summer of 1952 to cover the estate and gift tax fields. The major

portion of the work on the income tax has been completed. It is expected that the entire Project will be finished by 1954 or 1955. The work under this study is being made public in the form of Tentative Drafts, the latest of which are Numbers 6 and 7 and which together cover the income tax material through May, 1952. . . .

Those who seek a precise definition of "income" will not find complete solace in the Draft. On the contrary, as the Comments state, "Attempts to define 'income' have been unsatisfactory." The Eisner v. Macomber* definition—"Income may be defined as the gain derived from capital and from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets"—is vulnerable on several grounds. For one thing, it is incomplete, for it hardly covers income from a cancellation of indebtedness. And for the hard questions that lie at the periphery it would force a narrow dissection of the terms "capital" or "labor" in place of a broad consideration of the issues. Is the act of picking up found money "labor"? Is the activity required in an embezzlement "labor"? Essentially, the Eisner v. Macomber statement is a generalization rather than a definition.

The economists' definitions, apart from the fact that there is no unanimity among economists, are here not desirable. While they are helpful in indicating possible overall objectives of an income tax, they are neither appropriate for statutory use nor intended to be. For example, Henry Simons has defined personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." From the standpoint of tax administration this definition clearly covers too much ground—for example, all forms of imputed income would be included—and hence puts too great a strain on the exclusion sections. For much the same reasons, attempts to solve the problem by starting with all receipts as the taxable base and then subtracting those receipts which should not be taxed are equally unsatisfactory. Such an approach requires at the outset a definition of "receipt." Is a cancellation of indebtedness a "receipt" by the debtor? Does an assignment of income involve a "receipt" by the assignor? Next, it requires an enumeration of all those receipts which should not be taxed, a task which is as difficult as that which would be faced under the economists' definitions. Loans, capital replacements, perhaps imputed income, would have to be specifically excluded since they are "receipts." Our experience will always be insufficient to achieve a satisfactory itemization of all of the desired exclusions. The less rigid term "income" does not involve us in this exclusionary strait jacket. The "receipts" approach is thus neither a simplification nor a clarification of the tax base for an income tax.

The Supreme Court has recognized the futility of attempting to capture the concept of income and confine it within a phrase. In *United States* v. *Kirby Lumber Co.* the Court explicitly abandoned the search for a definition,** and succeeding cases have not revived the search. The courts have given a wide scope to the

* *Infra*, p 51. [Ed.]

** Holding that a taxpayer that had repurchased some of its own bonds for less than the price at which it had issued them realized income thereby, the Supreme Court (through Mr. Justice Holmes) there said: "We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here" 284 U.S. 1, 3 (1931). [Ed.]

income tax, but have recognized that the borderline content of "income" must be determined case by case. Essentially the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces. Each force and judicial reaction in turn reflects an underlying judgment as to what types of receipts should be subject to a tax imposed on "income."

It is believed that this combination of wide inclusiveness and elasticity should be retained, and that a simple reference to "all gains, profits, and income" is sufficient. It is also believed that familiar wording should be continued to avoid generating, by attempts to eliminate linguistic overlapping, new and nebulous problems of definition. Hence the Draft adheres to the old and seasoned terminology of "gains, profits, and income."...

In the income tax, as in other complex legislation, the need is for a standard which will project our present aims into the future and serve as the vehicle for solving the unforeseen cases as they arise. The legislative function is not denied or thwarted when other branches of the Government are relied upon by Congress to perform substantial tasks in the application of statutes. Administration and judicial interpretation are necessary parts of the overall process of legislation. The income tax is no exception. The general phrase "gains, profits, and income" is a satisfactory legislative command to the administrator and the judge. It provides a proper balance between the demand of a particular taxpayer that he should not be called upon to pay a tax without prior warning and the demands of all other taxpayers as a group that each particular taxpayer bear his proper part of the tax burden. The phrase is therefore retained in the Draft as a standard to solve the unforeseen cases until enough wisdom accumulates to build a more complete legislative solution to the problems of the future.

Section A. Non-Cash Benefits

UNITED STATES v. DRESCHER

United States Court of Appeals, Second Circuit, 1950
179 F 2d 863

Before L. HAND, Chief Judge, and SWAN, and CLARK, Circuit Judges.

SWAN, Circuit Judge.

This appeal brings up for review an action against the United States to recover additional income taxes for the years 1939 and 1940 which the plaintiff asserts were illegally assessed and collected. He was an officer and director of Bausch & Lomb Optical Company, and in each of the taxable years the Company purchased from an insurance company at a cost of $5,000 a single premium annuity contract naming him as the annuitant. The taxes in dispute resulted from the Commissioner's including such cost as additional compensation received by the plaintiff in the year when the annuity contract was purchased. The district court awarded the plaintiff judgment for overpayments in the aggregate amount of $5,924.22, ruling that he received no income in 1939 or 1940 attributable to the purchase of

the annuity contracts. The correctness of this ruling is presented by the appeal.

The facts are not in dispute. In 1936 the Optical Company inaugurated a plan to provide for the voluntary retirement at the age of 65 of its principal officers then under that age. There were five such, of whom Mr. Drescher was one. He was born April 28, 1894. Pursuant to this plan and in "recognition of prior services rendered," the Company purchased on December 28, 1939, and on the same date in 1940, a single premium, non-forfeitable annuity contract which named Mr. Drescher as the annuitant. Each policy was issued by Connecticut General Life Insurance Company and was delivered to the Optical Company which retained possession of it. It was the Company's intention, and so understood by the annuitant, that possession of the policy should be retained until the annuitant should reach the age of 65. The premium paid for each policy was $5,000. The amount of such payment was deducted by the Company in its tax return for the year of payment as part of the compensation paid to Mr. Drescher during that year. His salary as an officer was not reduced because of the purchase of the annuity contract, and he was not given the option to receive in cash the amounts expended by the Company for the premium payments. In filing income tax returns Mr. Drescher reported on the cash basis; the Optical Company on the accrual basis.

By the terms of the policy the Insurance Company agrees to pay the annuitant, commencing on December 28, 1958, a life income of $54.70 monthly under the 1939 policy and $44.80 monthly under the 1940 policy, with a minimum of 120 monthly payments. If the annuitant dies before receiving 120 monthly payments, the rest of them are payable to the beneficiary named in the policy. Each policy gives the annuitant an option to accelerate the date when monthly payments shall commence, but this option must be exercised by the annuitant in writing and endorsed on the policy. Consequently so long as the Optical Company retains possession of the policy the annuitant cannot exercise the option. If the annuitant dies before December 28, 1958, or before the acceleration date if he has exercised the option to accelerate monthly income payments, a death benefit is payable to the beneficiary designated by him (his wife). The policy reserves to him the right to change the beneficiary. The policy declares that "Neither this contract nor any payment hereunder may be assigned, and the contract and all payments shall be free from the claims of all creditors to the fullest extent permitted by law." The policy has no cash surrender, salable, or loan value, and does not entitle the annuitant to a distribution of surplus.

This case is governed by the provisions of the Internal Revenue Code as they existed in 1939 and 1940. The appellant contends that the contracts are taxable to the annuitant in the year of purchase by the employer because § 22(a), 26 U.S.C.A., sweeps into gross income "compensation for personal service, of whatever kind and whatever form paid, . . . and income derived from any source whatever." The taxpayer replies that these general provisions must be construed with regard to § 22(b) (2), printed in the margin,[1] as well as to § 165 relating to employees' trusts, and §§ 42 and 43 relating to accounting periods and methods of accounting. He cites Treasury rulings to the effect that retirement annuity contracts purchased for an employee gave rise to taxable income only as the annuitant

[1] Sec. 22(b) (2) "Annuities, etc.—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract, but if such amounts (when added

received payments under the contract; and that the entire amount of each annuity payment was includible in gross income for the year of its receipt if he had made no contribution toward the purchase of the annuity, while, if he had made contributions, he was taxable in the manner and to the extent provided in § 22 (b) (2) by the three per cent. rule.

Whether we should construe the statute in accord with these Treasury rulings if the matter were *res integra,* we need not say. In this court the question of construction is not *res integra* because of our decision in *Ward* v. *Commissioner,* 2 Cir., 159 F.2d 502. That case involved a single premium annuity contract delivered to the annuitant and assignable by him. We there held that "the petitioner became taxable in 1941 upon whatever value was, by the delivery of the policy to him in that year, then unconditionally placed at his disposal. . . . This was the then assignable value of the policy." 159 F.2d page 504. We then considered whether it was error to value the policy in the amount of the premium paid for it. We recognized that the assignable value of the policy in 1941 might be less than the single premium paid for it, but as the purchaser had offered no proof that it was we held that the Tax Court was right in treating "cost to the purchaser as the assignable value of the policy when received by the taxpayer." 159 F.2d page 505.

As we shall not overrule the Ward case, the question is narrowed to determining whether the present case is distinguishable because the plaintiff's policies are non-assignable and were retained in the possession of the employer. We do not think these facts are sufficient to distinguish the cases with respect to taxability of the contracts, although they may affect the value of the rights the respective annuitants acquired. It cannot be doubted that in 1939 the plaintiff received as compensation for prior services something of economic benefit which he had not previously had, namely, the obligation of the insurance company to pay money in the future to him or his designated beneficiaries on the terms stated in the policy. That obligation he acquired in 1939 notwithstanding the employer's retention of possession of the policy and notwithstanding its non-assignability. The perplexing problem is how to measure the value of the annuitant's rights at the date he acquired them. The taxpayer contends that they then had no present value, while the appellant argues that their value was equal to the premium paid by the employer. We are unable to accept either contention.

The prohibition against assignment does not prove complete absence of present value. The right to receive income payments which accrued to the plaintiff when the Optical Company received each contract represented a present economic benefit to him. It may not have been worth to him the amount his employer paid for it;

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to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph." [This method of taxing annuities was revised in 1954, see *infra.* p. 142. Ed.]

but it cannot be doubted that there is a figure, greater than zero although less than the premium cost, which it would have cost him to acquire identical rights. Likewise, the assurance that any beneficiary named by him at the time the contract was executed, or substituted by him at a later date, would in the event of his death receive the cost of each contract, plus interest after a few years, conferred a present economic benefit on him. Whatever present value the life insurance feature had to him is clearly taxable. See *Commissioner of Internal Revenue* v. *Bonwit*, 2 Cir., 87 F.2d 764, certiorari denied *Bonwit* v. *Helvering*, 302 U.S. 694, 58 S. Ct. 13, 82 L. Ed. 536. Another element of value inheres in the possibility that the annuitant could realize cash by contracting with a putative third person to hold in trust for him any payments to be received under the annuity contract. True, the promisee would run the risk that the annuitant might die before becoming entitled to any payments, in which event they would be payable to the beneficiary designated in the policy, but by exercising the reserved power to change the beneficiary the annuitant could designate his promisee. The power to make such a contract based on the policy may well have had some present value. No proof was offered as to this. For reasons which will be stated later the plaintiff had the burden of proving the amount by which he was overtaxed. On the other hand, it seems clear that the policy was worth less to the annuitant than the premium paid because the employer's retention of possession precluded him from exercising the privilege of accelerating the date of annuity payments since the insurance company's approval had to be endorsed upon the policy. The granting of this privilege must have been one of the factors taken into account in fixing the premium—at least, we may so assume in the absence of evidence. Hence deprivation of ability to exercise the privilege would decrease the value of the policy to the annuitant below its cost to the employer.

None of the authorities relied on by the parties is precisely in point on the issue of valuation. In *Hackett* v *Commissioner*, 1 Cir., 159 F.2d 121 although the policy was non-assignable, the value to the annuitant was measured by the cost of the premium. As already stated, that basis is inapplicable here, for retention of the policy by the employer cut off the acceleration privilege. The same distinction exists with respect to the partially assignable policy involved in *Oberwinder* v. *Commissioner*, 8 Cir., 147 F.2d 255. And the tax treatment of the assignable policy in that case, as well as of those involved in the *Ward* case and in *Hubbell* v. *Commissioner*, 6 Cir., 150 F.2d 516, 161 A.L.R. 764, affords little guidance to a correct valuation here. Likewise, the cases holding free from taxation a non-assignable promise to pay money at a future date do not assist us, since they rest decision on taxability—here concluded by the *Ward* case—rather than on valuation. But it is unnecessary on the present appeal to determine the precise valuation of the policies.

As already mentioned the burden of proving by how much he was overtaxed was on the plaintiff. He had paid the additional taxes assessed upon the valuation ascribed by the Commissioner to the annuity contracts. An action to recover taxes erroneously collected is essentially an action for money had and received and unjustly detained by the defendant. *Stone* v. *White*, 301 U S. 532, 57 S. Ct. 851, 81 L. Ed. 1265; *DeGuire* v. *Higgins*, 2 Cir., 159 F.2d 921. Hence the plaintiff must show how much was unjustly detained. He relied upon the terms of the

contract to prove that it had no present value whatever. But for reasons already stated we are satisfied that the 1939 policy had some present value and since he did not prove that such value was less than $5,000, the judgment in his favor cannot stand. . . .

Judgment reversed and cause remanded.

CLARK, Circuit Judge *(dissenting in part).*

I agree that the judgment must be reversed, but do not share in the view that some amount less than the $5,000 expended by the employer for this taxpayer in each of the years in question may be found to be the value of the annuity and hence the amount of additional compensation for which he is to be taxed. For the contrary seems to me well supported in reason and well established by the authorities cited in the opinion, some directly in point and some with, I suggest, immaterial variations of fact. In the light of modern conditions of life, the satisfying of the highly natural and indeed burning desire of most men of middle age to obtain security for their old age and for their widows at death seems so clearly an economic benefit that I wonder it has been questioned as much as it has. Nor do I see the need to support this conclusion by looking for some highly theoretical possibility of turning this benefit into immediate dollars and cents any more than in the case where an employee is furnished living quarters or meals. Just as the latter are valued as additional compensation, though not assigned or assignable, so I think this highly valuable security is a purchased benefit for these company executives. Consequently the making of nice distinctions in either taxability or the amount thereof between assignable or accelerable annuities or their delivery or retention by the company—after careful forethought and advice of its attorneys with naturally an eye on both pension and tax possibilities—seems to me improper, when the general purpose to make adequate retirement provisions for these employees was made so clear.

Hence for any issues here involved I do not think it is important to discover what reasons impelled the employer to make the slightly differing provisions from those before this court in *Ward* v. *Commissioner*, 2 Cir., 159 F.2d 502, 505. Perhaps the employer may have had the prescience to foresee these tax problems which are troubling my brothers and did trouble the court below and may result in at least postponement, if not non-collectibility, of most, if not all, of the tax on the additional return provided by the employer for these executives. Perhaps, rather, the employer was providing only for a surer provision "free from the claims of all creditors to the fullest extent permitted by law" for this taxpayer and his wife. So in retaining possession of the policies and cherishing the present intent not to permit acceleration of the annuities, the employer may have had in mind a way of both securing the purchased services to the retirement age in normal cases and guarding against unusual situations due to disability or other special cause. In any event the fact is that the employer purchased at the going insurance rate those contracts which for the parties fulfilled the conditions desired.[1] Actually they would return to the annuitant, or to his

[1] This was a tightly controlled corporation, so much so that the executives receiving the annuities and their families owned approximately 35 per cent of the voting stock, while the older officers and directors owned approximately 57 per cent. Hence there was never a sharp divergency of interest between these executives and their employer.

widow, total amounts at least well in excess of the premiums paid and increasing yet more the longer he lived. The parties got just what they paid for in the insurance market, and its cost price is the additional compensation the executive received. The two features stressed in the opinion, namely, the nonassignability and the present non-accelerability of the annuities, may add to their usability for the particular purpose, but would seem not to change the basis of value. Perhaps, indeed, they render the contracts more desirable not only to the employer, but also to the annuitant's wife, as making the security provisions less easily impaired, and thus have a special appeal to a husband solicitous of his wife's future. At least, I do not see what basis we have for thinking they adversely affect values of provisions for a particular purpose, *viz.*, security. If, in fact, these conditions do affect the amount of the premium, as the opinion rather naturally assumes, then all the more is the bargain of the parties to be respected as made; even the annuitant would doubtless be interested in a maximum return though it be strictly limited to himself or his wife. It seems to me that there is being set up some premise, not found in any of the precedents, of a fictitious partly-impaired transferability which is now somehow to be given a value in place of the wholly practical values set upon these contracts in the insurance market itself.

Of the cases, *Hackett* v. *Commissioner*, 1 Cir., 159 F.2d 121, seems directly in point and Judge Mahoney's opinion wholly persuasive as to both the meaning of the statute and the value to be set upon a nonassignable annuity contract. The suggested ground of distinction, that here retention of the policy by the employer cut off the acceleration privilege, cannot be accepted, since there does not appear to have been any such privilege in the annuity there considered; for no mention of the fact, or allusion of any kind to it, is made by the court. The same is true in *Oberwinder* v. *Commissioner*, 8 Cir., 147 F.2d 255, which also appears to be on all fours with this case. Similar results were reached in *Hubbell* v. *Commissioner*, 6 Cir, 150 F.2d 516, 161 A.L.R. 764, and by this court in *Ward* v. *Commissioner, supra;* for the reasons I have stated, the fact that the annuities in these cases were assignable should not make their purchase price any more accurate a gauge of their value than is the purchase price here. A like conclusion has been reached with respect to insurance premiums, *Commissioner of Internal Revenue* v. *Bonwit*, 2 Cir., 87 F.2d 764, certiorari denied *Bonwit* v. *Helvering*, 302 U.S. 694, 58 S. Ct. 13, 82 L. Ed. 536, and amounts deposited in the federal Civil Service Retirement Fund, *Miller* v. *Commissioner*, 4 Cir., 144 F.2d 287, while no case supporting a lesser valuation has been discovered True, in the *Ward* case we spoke of the failure of the taxpayer "to show that the contract was not worth as much as it cost." Surely there is nothing in this record to suggest anything different. Here there was even an official of the insurance company to testify to the somewhat ordinary nature of these contracts. That the parties actually got the particular provisions they desired for their purposes does not at all suggest that the policies were overpriced.

Hence unless these benefits are now taxed, this small group of top executives will be given a tax advantage not accruing to less fortunate or less well-advised persons. Such taxation should not be confused or rendered abortive by directions for valuation impossible of execution in any realistic way.

BENAGLIA v. COMMISSIONER

Board of Tax Appeals, 1937
36 B.T.A. 838

STERNHAGEN: The Commissioner has added $7,845, each year to the petitioner's gross income as "compensation received from Hawaiian Hotels, Ltd.", holding that this is "the fair market value of rooms and meals furnished by the employer." In the deficiency notice he cites article 52[53], Regulations 77, and holds inapplicable *Jones* v. *United States,* 60 Ct. Cls. 552, I.T. 2232; G.C.M. 14710; and G.C.M. 14836. The deficiency notice seems to hold that the rooms and meals were not in fact supplied "merely as a convenience to the hotels" of the employer.

From the evidence, there remains no room for doubt that the petitioner's residence at the hotel was not by way of compensation for his services, not for his personal convenience, comfort, or pleasure, but solely because he could not otherwise perform the services required of him. The evidence of both the employer and employee shows in detail what petitioner's duties were and why his residence in the hotel was necessary. His duty was continuous and required his presence at a moment's call. He had a lifelong experience in hotel management and operation in the United States, Canada, and elsewhere, and testified that the functions of the manager could not have been performed by one living outside the hotel, especially a resort hotel such as this. The demands and requirements of guests are numerous, various, and unpredictable, and affect the meals, the rooms, the entertainment, and everything else about the hotel. The manager must be alert to all these things day and night. He would not consider undertaking the job and the owners of the hotel would not consider employing a manager unless he lived there. This was implicit throughout his employment, and when his compensation was changed from time to time no mention was ever made of it. Both took it for granted. The corporation's books carried no accounting for the petitioner's meals, rooms, or service.

Under such circumstances, the value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear. In *Jones* v. *United States, supra,* the subject was fully considered in determining that neither the value of quarters nor the amount received as commutation of quarters by an Army officer is included within his taxable income. There is also a full discussion in the English case of *Tennant* v. *Smith,* H.L. (1892) App. Cas. 150, III British Tax Cases 158. A bank employee was required to live in quarters located in the bank building, and it was held that the value of such lodging was not taxable income. The advantage to him was merely an incident of the performance of his duty, but its character for tax purposes was controlled by the dominant fact that the occupation of the premises was imposed upon him for the convenience of the employer. The Bureau of Internal Revenue has almost consistently applied the same doctrine in its published rulings.

The three cases cited by the respondent, *Ralph Kitchen,* 11 B.T.A. 855; *Charles A. Frueauff,* 30 B.T.A. 449; and *Fontaine Fox,* 30 B.T.A. 451, are distinguishable entirely upon the ground that what the taxpayer received was not shown to be primarily for the need or convenience of the employer. Of course, as in the *Kitchen* case, it can not be said as a categorical proposition of law that, where

an employee is fed and lodged by his employer, no part of the value of such perquisite is income. If the Commissioner finds that it was received as compensation and holds it to be taxable income, the taxpayer contesting this before the Board must prove by evidence that it is not income. In the *Kitchen* case the Board held that the evidence did not establish that the food and lodging were given for the convenience of the employer. In the present case the evidence clearly establishes that fact, and it has been so found.

The determination of the Commissioner on the point in issue is reversed.

Reviewed by the Board.

Judgment will be entered under Rule 50. MURDOCK concurs only in the result.

ARNOLD, *dissenting:* I disagree with the conclusions of fact that the suite of rooms and meals furnished petitioner and his wife at the Royal Hawaiian Hotel were entirely for the convenience of the employer and that the cash salary was fixed without reference thereto and was never regarded as part of his compensation.

Petitioner was employed by a hotel corporation operating two resort hotels in Honolulu—the Royal Hawaiian, containing 357 guest bed rooms, and the Moana, containing 261 guest bed rooms, and the bungalows and cottages in connection with the Moana containing 127 guest bed rooms, and the Waialae Golf Club. His employment was as general manager of both hotels and the golf club.

His original employment was in 1925, and in accepting the employment he wrote a letter to the party representing the employer, with whom he conducted the negotiations for employment, under date of September 10, 1925, in which he says:

> Confirming our meeting here today, it is understood that I will assume the position of general manager of both the Royal Waikiki Beach Hotel (now under construction) and the Moana Hotel in Honolulu, at a yearly salary of $10,000.00, payable monthly, together with living quarters, meals, etc., for myself and wife In addition I am to receive $20.00 per day while travelling, this however, not to include any railroad or steamship fares, and I to submit vouchers monthly covering all such expenses.

While the cash salary was adjusted from time to time by agreement of the parties, depending on the amount of business done, it appears that the question of living quarters, meals, *etc.*, was not given further consideration and was not thereafter changed. Petitioner and his wife have always occupied living quarters in the Royal Hawaiian Hotel and received their meals from the time he first accepted the employment down through the years before us. His wife performed no services for the hotel company.

This letter, in my opinion, constitutes the basic contract of employment and clearly shows that the living quarters, meals, *etc.*, furnished petitioner and his wife were understood and intended to be compensation in addition to the cash salary paid him. Being compensation to petitioner in addition to the cash salary paid him, it follows that the reasonable value thereof to petitioner is taxable income. *Cf. Ralph Kitchen,* 11 B.T.A. 855; *Charles A. Frueauff,* 30 B.T.A. 449.

Conceding that petitioner was required to live at the hotel and that his living there was solely for the convenience of the employer, it does not follow that he was not benefited thereby to the extent of what such accommodations were reasonably worth to him. His employment was a matter of private contract. He was careful to specify in his letter accepting the employment that he was to be

furnished with living quarters, meals, *etc.*, for himself and wife, together with the cash salary, as compensation for his employment. Living quarters and meals are necessities which he would otherwise have had to procure at his own expense. His contract of employment relieved him to that extent. He has been enriched to the extent of what they are reasonably worth.

The majority opinion is based on the finding that petitioner's residence at the hotel was solely for the convenience of the employer and, therefore, not income. While it is no doubt convenient to have the manager reside in the hotel, I do not think the question here is one of convenience or of benefit to the employer. What the tax law is concerned with is whether or not petitioner was financially benefited by having living quarters furnished to himself and wife. He may have preferred to live elsewhere, but we are dealing with the financial aspect of petitioner's relation to his employer, not his preference. He says it would cost him $3,600 per year to live elsewhere.

It would seem that if his occupancy of quarters at the Royal Hawaiian was necessary and solely for the benefit of the employer, occupancy of premises at the Moana would be just as essential so far as the management of the Moana was concerned. He did not have living quarters or meals for himself and wife at the Moana and he was general manager of both and both were in operation during the years before us. Furthermore, it appears that petitioner was absent from Honolulu from March 24 to June 8 and from August 19 to November 2 in 1933, and from April 8 to May 24 and from September 3 to November 1 in 1934—about 5 months in 1933 and 3½ months in 1934. Whether he was away on official business or not we do not know. During his absence both hotels continued in operation. The $20 per day travel allowance in his letter of acceptance indicates his duties were not confined to managing the hotels in Honolulu, and the entire letter indicates he was to receive maintenance, whether in Honolulu or elsewhere, in addition to his cash salary.

At most the arrangement as to living quarters and meals was of mutual benefit, and to the extent it benefited petitioner it was compensation in addition to his cash salary, and taxable to him as income.

The Court of Claims in the case of *Jones* v. *United States*, relied on in the majority opinion, was dealing with a governmental organization regulated by military law where the compensation was fixed by law and not subject to private contract. The English case of *Tennant* v. *Smith*, involved the employment of a watchman or custodian for a bank whose presence at the bank was at all times a matter of necessity demanded by the employer as a condition of the employment. The facts in both these cases are so at variance with the facts in this case that they are not controlling in my opinion.

SMITH, TURNER and HARRON agree with this dissent.

MIMEOGRAPH 6472

Bureau of Internal Revenue, 1950

1950-1 C.B. 15

1. Section 22(a) of the Internal Revenue Code defines gross income as including "gains, profits, and income derived from salaries, wages, or compensation for

personal service . . . of whatever kind and in whatever form paid, . . ." Section 39.22(a)-3 of Regulations 118, relating to compensation paid other than in cash, provides in part as follows. ". . . If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees. . . ."

Similar language is contained in section 405.101 of Regulations 116, relating to wages subject to withholding of income tax at the source.

2. The first sentence of the above-quoted regulation adheres closely to the definition of gross income included in section 22(a) of the Internal Revenue Code and establishes the general rule that every person receiving living quarters or meals "as compensation for services rendered" must include in gross income the value to him of such quarters or meals. The second sentence quoted above must be construed in the light of the first sentence to avoid being inconsistent therewith and to prevent violation of the statutory definition of gross income. The "convenience of the employer" rule is simply an administrative test to be applied only in cases in which the compensatory character of such benefits is not otherwise determinable. It follows that the rule should not be applied in any case in which it is evident from the other circumstances involved that the receipt of quarters or meals by the employee represents compensation for services rendered. This position is in accord with I.T. 2692 (C.B.XII-1, 28 (1933), and the decision of the United States Board of Tax Appeals (now The Tax Court of the United States) in *Herman Martin* v. *Commissioner* (44 B.T.A. 185).

3. For example, a State civil service employee is employed at an institution in which the conditions of employment require him to live at the institution and be available for duty at any time. In connection with his employment, he is furnished living quarters and meals. Under the applicable State statute, the civil service rules and regulations of the State, or the individual contract of employment, the value of the living quarters and meals is considered as part of the employee's compensation. Regardless of whether living quarters and meals are furnished in addition to the cash salary, or the value thereof is deducted from the total salary, established for the particular position, it is evident that the living quarters and meals are furnished as compensation for services rendered. Consequently, the value of the living quarters and meals is includible in his gross income and is subject to withholding of income tax at the source by the employer, notwithstanding the fact that the employee is required to live at the institution and be available for duty at any time.

Note

1. Before the 1954 Code was enacted, there was no statutory provision dealing with meals and lodging supplied by employers to employees But the Regulations for many years included the statement quoted in the first paragraph of Mim. 6472, *supra* Apparently the American source for the "convenience of the employer" doctrine was *Jones* v. *United States*, cited in the *Benaglia* case.

If the nature of the services require the furnishing of a house for their proper performance, and without it the service may not be properly rendered, the house

so furnished is part of the maintenance of the general enterprise, an overhead expense, so to speak, and forms no part of the individual income of the laborer. . . . It is indeed far from impressive that where an employer, in the course of the promotion and efficiency of the enterprise in which he is engaged, must of necessity provide the indispensable facilities for the successful prosecution of the same, because perchance an employee in the not to be avoided course of his duties may be in a position to avoid an expense which in a different character of service he might be obliged to incur, that therefore the use of the facility constitutes income. 60 Ct. Cl. 552, 575, 577 (1925).

2. Section 119 of the 1954 Code should be examined with care. To what extent is earlier law modified? Is it now necessary to determine whether meals or lodging are "intended as compensation?" Even though § 119 provides that the terms of an employment contract or state statute are not "determinative," are they significant in deciding whether the meals or lodging are excluded by § 119? Are meals or lodging furnished to members of the employee's family within the meaning of § 119? Lodging is excluded only if the employee "is required to accept such lodging on the business premises of his employer as a condition of his employment." Does this automatically insure that the lodging was furnished "for the convenience of the employer?" Can meals be excluded even if the employee is not "required to accept" them "as a condition of his employment?" Was this requirement omitted from § 119(1) only because employers do not customarily force-feed their employees, or is there some difference between meals and lodging so far as the requirement of acceptance as a condition of employment is concerned?

3. Why the stress on "compensation" in both the *Benaglia* case, *supra*, and the ruling? The Sixteenth Amendment speaks of "incomes, from whatever source derived." Section 22(a) of the 1939 Code embraced not only "income derived from salaries, wages, or compensation for personal service," but also "gains or profits and income derived from any source whatever." Must a benefit accruing to an employee be "compensation" to be taxable?

Perhaps the quarters furnished to soldiers in the field, to Pullman porters, to men in construction camps, *etc.*, are entirely non-compensatory, at least if the recipient is a married man and must maintain his usual place of abode for his family. But can the quarters of a hotel manager, a college president, an army officer in peace-time, *etc.* be realistically termed non-compensatory? So viewed, are meals ever non-compensatory? Bittker, "The Individual as Wage Earner," *11th Annual N Y.U. Inst. on Fed. Taxation* 1147 (1953).

4. What are the administrative problems of taxing compensation in kind? See Guttentag, Leonard, and Rodewald, "Federal Income Taxation of Fringe Benefits: A Specific Proposal," 6 *Nat'l. Tax J.* 250 (1953). Other tax and regulatory statutes must also cope with compensation in kind. See Comment, Tax Treatment of Compensation in Kind, 37 *Calif. L. Rev.* 628 (1949). Under the Social Security Act, the Treasury has ruled that "facilities and privileges" (such as cafeterias, medical service, or courtesy discounts) furnished by the employer will not be treated as a part of taxable wages if "offered or furnished by the employer merely as a convenience to the employer or as a means of promoting the health, good will, contentment, or efficiency of his employees." Regs. 90, Art. 207. The Treasury has ruled that this exclusion ordinarily embraces only "items which are insubstantial in character and value" and not "board and lodging." S.S.T. 321, 1938–2 C.B. 323. Is there any justification for including meals and quarters when calculating the employer's social security taxes and the employee's benefits but excluding them in computing the employee's income tax? See *Pacific American Fisheries* v. *United States*, 138 F.2d 464 (9th Cir. 1943).

5. Consider the tax status of these three individuals. *A* works for $75 a week for the *X* Co., which makes available to its employees a cafeteria serving inexpensive meals, medical and dental service caring for the entire family, an extensive program of social and recreational activities, and a discount on purchases of its goods. These "fringe benefits" cost the employer, on the average, $5 weekly per employee. *B* receives $80 a week

in identical employment for the *Y* Co., which offers its employees no such benefits. *C* receives $77.50 for identical work at *Z* Co., which offers no fringe benefits, but which has more pleasant lighting, air-conditioning, and foremen These attractions cost *Z* Co. about $2.50 weekly per employee.

GEESEMAN v. COMMISSIONER

Board of Tax Appeals, 1938
38 B.T.A. 258

[Pursuant to a plan adopted by the stockholders of Continental Can Co., the taxpayer's employer, its board of directors in 1931 granted to the taxpayer the right to purchase 800 shares of its common stock at $40 (later reduced to $30) per share, the option being exercisable in equal installments over the years 1931–34. The option contract stated that the employer "recognizing the value to it of the continuance of the services of D.B. Geeseman . . . and desiring the continuance of such services, grants to the Employee" the option. It also provided that if the taxpayer was discharged or resigned or died prior to the expiration date of the contract (September 2, 1935), he or his estate could purchase only the installments which had accrued at the time of the discharge, resignation, or death.

[When the option was granted, the stock was selling on the New York Stock Exchange at about 58 and it fluctuated from then to the end of 1933 between 33 and 72. In 1933 the taxpayer purchased 640 shares for $19,200. When purchased, the shares were worth about $45,000, and the Commissioner asserted that the "spread" was income to the taxpayer.

[The employer did not deduct the difference between the option price and the value of the shares when the option was granted as additional compensation. When the options were exercised in 1933, however, it did deduct the "spread" as additional compensation, though it had not done so for options exercised in 1931 or 1932.]

TURNER: The respondent contends that the option granted the petitioner "by its terms was strictly an employment of service contract" and that the difference between the price paid for the shares of stock and their fair market value on the date of purchase was additional compensation received by him as an employee of Continental Can Co. The petitioner contends that his purchase of stock was a "bargain" purchase and that such acquisition does not result in the realization of gain until the shares are sold or otherwise disposed of at a profit. In the alternative, he contends that if the transaction did constitute the payment of compensation, such compensation was received either when the option was originally granted or on the respective dates when the right to acquire the various allotments of stock matured.

Numerous cases which resemble the instant case in many respects have been decided and the results in many of them can not be reconciled as to conclusions of fact or conclusions of law. The disposition of such cases has become increasingly difficult because of the effort to spell out some set rule or formula whereby transactions of the type here involved may be automatically classified either as "bargain" purchases having no dependency on a contract of employment and which in the absence of sale or other disposition of the shares are said not to

result in the present realization of gain, or classified as the payment of compensation which, to the extent that the fair market value of the shares on the date of acquisition exceeds the purchase price, must be returned by the employee as income in the year of the purchase. To hold that a transaction of the character here involved is a "bargain" purchase having nothing to do with the employer-employee relationship, or, to the contrary, that it is not a purchase but constitutes the receipt of compensation having nothing to do with the purchase of property, to the extent that the fair market value exceeds the purchase price, is to ignore obvious facts and to assume a case substantially different from the one before us. In the first place, it may not be said that the acquisition of the stock of Continental Can Co. was not a purchase merely because the price paid was substantially lower than the price at which the same stock was then selling on the market, and, in the second place, obvious facts are ignored if it be said that the stock transaction was separate and apart from, or was not based upon, the employer-employee relationship, or that it had no relation to services rendered or to be rendered. In practically all such cases both elements are present and decision is impossible if the absence of one or the other is essential thereto.

Normally the purchase of property does not result in the realization of taxable gain, but rather in the acquisition of an asset with a view to the later realization of gain or profit through its use or subsequent sale, and upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital. *Burnet* v. *Logan*, 283 U.S. 404. Certainly the above principle is applicable in the instant case in so far as the stock acquired by the petitioner under the option granted to him by his employer was acquired at a cost to him of $30 per share in cash. It is also equally obvious that the petitioner did not at the time of or in the year of purchase recover any part of such cost. Our question then is whether on the facts presented it must be said that some undivided part of the 640 shares of Continental Can acquired by the petitioner was acquired by purchase and in respect of that part no taxable gain is realized until the stock is sold or otherwise disposed of and the petitioner has recovered his cost, while saying that the remaining undivided part of the said shares was received as the payment of compensation and must be reported as income in the year received to the extent of the fair market value of such undivided part. If so, it must be because of the fact that the price paid was lower than the price at which the same stock was selling on the market either at the time of purchase or at the time the offer was extended or became effective; otherwise, there would be no basis for holding that any portion of the stock was acquired other than by purchase, even though the sale to petitioner was based on an employer-employee relationship. *Gardner-Denver Co.* v. *Commissioner*, 75 Fed. (2d) 38. Furthermore it is not at all unusual that the purchaser of property may through his ability and shrewdness as a buyer, or by reason of other influences or forces, be able to purchase property at a price substantially lower than the price at which it may be immediately sold, but it does not follow that gain is presently realized through such a purchase. *Manomet Cranberry Co.*, 1 B.T.A. 706; *Morgan J. McMichael*, 4 B.T.A. 266; *George W. Van Vorst, Executor*, 22 B.T.A. 632; affd., 59 Fed. (2d) 667; *James William Everhart*, 26 B.T.A. 318; *W. L. Dunn*, 14 B.T.A. 13; and *Rose* v. *Trust Co. of Georgia*, 28 Fed. (2d) 767. Accordingly it is our opinion that as a prerequisite to the conclusion sought by the respondent it should def-

initely and clearly appear that a transaction, which in form is nothing more than a purchase and to an obvious and substantial extent is unquestionably a purchase, is in fact to some extent the payment of compensation for services rendered or to be rendered.

If the agreement between an employer and employee shows that the amount of money which is to be paid by the employee in connection with the acquisition of stock in the employer is fixed or controlled by services rendered or to be rendered and further shows that the employee agrees to receive payment of his compensation in the form of stock, the parties should not be heard to say that the excess of the fair market value of the stock over the cash paid by the employee should not be treated for income tax purposes as compensation paid. *Albert Russel Erskine*, 26 B.T.A. 147. *Cf. W. M. Ritter Lumber Co.*, 30 B.T.A. 231. It is also possible that even in the absence of such a definite understanding or expressed declaration in the agreement between the employer and employee, the circumstances surrounding the agreement may be such as to render unreasonable and absurd any conclusion that the acquisition of the stock at the price named did not constitute the payment of compensation to the extent of the difference between the amount paid and the fair market value of the stock. Such, however, is not the case before us. It is true that the prospective purchasers were selected solely because they were valued employees of Continental Can Co., and there is no doubt that the added interest of these employees and the proprietary attitude toward the company which would result from their ownership of the stock constituted one of the motives for the granting of the option. It is equally obvious, however, that the continued employment of the petitioner was not dependent upon the receipt by him of the right to purchase the stock at less than the market price. The terms and conditions of his employment and the compensation he was receiving were in no way changed by the receipt of the privilege of purchasing the stock. Accordingly the rule stated in the *Erskine* and *Ritter Lumber Co.* cases is not applicable here. Furthermore the price to be paid by petitioner for the stock was substantial and, if consideration be given to the language of the offer, the margin of difference between the option price and the current market price at the time the option price was fixed, and to the fluctuation of prices on the stock market during the period in which the offer was made, we do not believe that it can be said that the margin of difference between the offering price and the fair market value of the stock was so great as to require the conclusion that the transaction here constituted the payment of compensation. *Cf. Omaha National Bank* v. *Commissioner*, 75 Fed. (2d) 434; *Gardner-Denver Co., supra;* and *Rossheim* v. *Commissioner*, 92 Fed. (2d) 247. Accordingly we are unable to find in the instant case the elements which would indicate that the transaction was not what its form indicates, that is, a purchase of stock by the petitioner with a view to the subsequent realization of profit through dividends or sale or other disposition of the property.

The conclusion stated makes it unnecessary to consider the petitioner's alternative contentions.

Decision will be entered for the petitioner.

Note

1. In *Commissioner* v. *Smith,* 324 U.S. 177 (1945), the Supreme Court held that the "spread" was income to an employee in the year the option was exercised. The Tax Court had found that the option in question was issued to the employee "as compensation for services" and that it had no ascertainable market value when issued. The Supreme Court said (324 U.S. at 181–2):

> Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected . . . the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise of the option given for that purpose. It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation.

The *Smith* case led, in 1946, to an amendment to the Regulations, flatly declaring:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. Regs. 118, Sec. 39.22(a)-1.

The amended regulation has been the center of controversy. Friedman and Silbert, "Stock Option and Stock Purchase Plans," *8th Annual N.Y.U. Inst. on Fed. Taxation* 433 (1950), Comment, The Treasury's Proposal to Tax Employees' Bargain Purchases T.D. 5507, 56 *Yale L.J.* 706 (1947). In 1950, the Senate Finance Committee stated that it "believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v *Smith,* 324 U.S. 177 (1945)." S. Rept. No. 2375, 81st Cong., 2d sess., reprinted in 50–2 C.B. 483, 526 The Tax Court has continued to apply the *Geeseman* case to options granted before the amended regulation, which was intended to be prospective only, was issued (see *Rosenberg* v. *Commissioner,* 20 T.C. 5 1953) and, in *LoBue* v. *Commissioner,* 22 T.C. No. 58 (1954), it refused to apply the amended regulation to a post-1946 stock option, saying that it believed that the criteria of the *Geeseman* case are "still the most reliable guide to be followed" Four judges dissented, but without opinion.

2. Would the amended regulation apply to property purchased pursuant to a "courtesy discount?" To meals served for less than value or cost in an employees' lunchroom? For the circumstances that may lead to treating the *issue* of the option, rather than its exercise, as "the only intended compensation" (in the words of the *Smith* case), see *McNamara* v. *Commissioner,* 210 F.2d 505 (7th Cir. 1954).

3. The amended regulation, in conjunction with earlier doubts as to the breadth of the *Geeseman* doctrine, discouraged the issuance of employee stock options after 1946. The Revenue Act of 1950 added § 130A to the 1939 Code, providing favorable tax treatment for so-called "restricted stock options." As a result of these tax benefits, considered in Chapter 5, stock options have once more become a popular device for compensating corporate employees, especially executives. Options that do not meet the qualifications of the statute, however, may possibly still be entitled to go tax-free if they are non-compensatory within the *Geeseman* doctrine. Washington and Rothschild, *Compensating the Corporate Executive,* 143–147 (rev. ed. 1951). Section 130A was rewritten by the 1954 Code and, as modified, appears as § 421

4. Note that even if the option is "compensatory" and does not qualify under § 421, taxing the "spread" requires a determination of the stock's fair market value. Suppose the stock is made non-transferable for a limited period of time and the employer retains the right to reacquire the stock at the sales price if the employee voluntarily

leaves his job. It has been held that such restrictions on transfer may deprive the stock of a fair market value and thus prevent the assessment of tax when the option is exercised. *Kuchman* v. *Commissioner,* 18 T.C. 154 (1952). *A fortiori* the option itself would lack an ascertainable market value so as to permit a tax to be assessed in the year it was issued. Moreover, it was held in *Lehman* v. *Commissioner,* 17 T.C. 652 (1951), that the "spread" between cost and fair market value could not be taxed in the year in which the restrictions on transfer expired:

> Termination of the restrictions was not a taxable event such as the receipt of compensation for services or the disposition of property. Values fluctuate from time to time and the value on a later date might be out of all proportion to the compensation involved in the original acquisition of the shares.

Section B. The Requirement of a "Realization"

EISNER v. MACOMBER

Supreme Court of the U.S., 1920

252 U.S. 189

MR. JUSTICE PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916 (39 Stat. 756 *et seq.,* c. 463 Comp. St. Sec. 6336a *et seq.*), which, in our opinion . . . plainly evinces the purpose of Congress to tax stock dividends as income.

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 per cent, or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the Commissioner of Internal

Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated Article 1, Sec. 2, Cl. 3, and Article 1, Sec. 9, Cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. . . .

The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601, 15 Sup. Ct. 912, 39 L. Ed. 1108, under the Act of August 27, 1894 (28 Stat. 509, 553, c. 349, Sec. 27), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by Article 1, Sec. 2, Cl. 3, and Section 9, Cl. 4, of the original Constitution.

Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. . . .

A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that the clauses cited from Article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use *(Bouv. L.D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.)*, we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence* v. *Howbert*, 231 U.S. 399, 415, 34 Sup. Ct. 136, 140, 58 L. Ed. 285, *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, 185, 38 Sup. Ct. 467, 469, 62 L. Ed. 1054), "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* Case, 247 U.S. 183, 185, 38 Sup. Ct. 467, 469 (62 L. Ed. 1054).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "Derived-from-capital"; "the gain-derived-from-capital," *etc.* Here we have the essential matter: *not* a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being "derived"—that is, received or drawn by the recipient (the taxpayer), for his separate use, benefit and disposal—that is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment—"incomes, from whatever source derived"—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. . . .

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company he can do so only by disposing of his stock.

For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested. . . .

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment. . . .

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths

instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock, it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax....

We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners, when they are not such, treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values—a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the

present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal. . . .

MR. JUSTICE HOLMES *dissenting*. . . .

I think that the word "incomes" in the Sixteenth Amendment should be read in "a sense most obvious to the common understanding at the time of its adoption." *Bishop* v. *State*, 149 Ind. 223, 230, 48 N.E. 1038, 1040, 39 L.R.A. 278, 63 Am. St. Rep. 270; *State* v. *Butler*, 70 Fla. 102, 133, 69 South. 771. For it was for public adoption that it was proposed. *McCulloch* v. *Maryland*, 4 Wheat. 316, 407, 4 L. Ed. 579. The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. See *Tax Commissioner* v. *Putnam*, 227 Mass. 522, 532, 533, 116 N.E. 904, L.R.A. 1917F, 806.

MR. JUSTICE DAY concurs in this opinion.

MR. JUSTICE BRANDEIS delivered the following *dissenting* opinion:

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits, among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. Arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and, at the same time, for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many

years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend....

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky; that is, issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased—the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income...

Suppose that a corporation having power to buy and sell its own stock, purchases in the interval between its regular dividend dates, with moneys derived from current profits, some of its own common stock as a temporary investment, intending at the time of purchase to sell it before the next dividend date and to use the proceeds in paying dividends, but later, deeming it inadvisable either to sell this stock or to raise by borrowing the money necessary to pay the regular dividend in cash, declares a dividend payable in this stock; can any one doubt that in such a case the dividend in common stock would be income of the stockholder and constitutionally taxable as such? See *Green* v. *Bissell*, 79 Conn. 547, 65 Atl. 1056, 8 L.R.A. (N.S.) 1011, 118 Am. St. Rep. 156, 9 Ann. Cas. 287; *Leland* v. *Hayden*, 102 Mass. 542. And would it not likewise be income of the stockholder subject to taxation if the purpose of the company in buying the stock so distributed had been from the beginning to take it off the market and distribute it among the stockholders as a dividend, and the company actually did so? And proceeding a short step further: Suppose that a corporation decided to capitalize some of its accumulated profits by creating additional common stock and selling the same to raise working capital, but after the stock has been issued and certificates therefor are delivered to the bankers for sale, general financial conditions make it undesirable to market the stock and the company concludes that it is wiser to husband, for working capital, the cash which it had intended to use in paying stockholders a dividend, and, instead, to pay the dividend in the common stock which it had planned to sell; would not the stock so distributed be a distribution of profits—and hence, when received, be income of the stockholder and taxable as such? If this be conceded, why should it not be equally income of the stockholder, and taxable as such, if the common stock created by capitalizing profits, had been originally

created for the express purpose of being distributed as a dividend to the stockholder who afterwards received it? . . .

MR. JUSTICE CLARKE concurs in this opinion.

Note

Eisner v. *Macomber* has been included at this point because of its discussion of the term "income." The subsequent statutory and judicial treatment of stock dividends must be reserved for detailed examination later. See Chapter 6, Sec. H(1). No other income tax case has been as extensively and acutely discussed as *Eisner* v. *Macomber*.* A classic article by Thomas Reed Powell is, "Stock Dividends, Direct Taxes, and the Sixteenth Amendment," 20 *Col. L. Rev.* 536 (1920); he concludes that the majority justices are better economists than the minority but finds a "stalemate" in the legal battle. E. R. A. Seligman, the distinguished economist, supported the majority, *Studies in Public Finance*, Chapter 5, while his son, an attorney, preferred the dissents, "Implications and Effects of the Stock Dividend Decision," 21 *Col. L. Rev.* 313 (1921). Henry Simons, who ordinarily had little use for the views of Seligman père, nevertheless agreed with him in approving the result of the decision, though he could not accept the opinion:

> The decision that stock dividends should be ignored in calculating taxable income (except for the appropriate changes in the basis from which capital gains and losses are measured) was eminently sound, as a judgment about a question of legislative policy. It is most unfortunate, however, that a constitutional issue was ever raised; for brief experience with the legislation in question would almost certainly have led to general disapproval and early repeal. . . . Actually, an utterly trivial issue was made the occasion for injecting into our fundamental law a mass of rhetorical confusion which no orderly mind can contemplate respectfully, and for giving constitutional status to naive and ridiculous notions about the nature of income and the rationale of income taxes. (Simons, *Personal Income Taxation* 198-199 (1938)).

But see Surrey, "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill L. Rev.* 779 (1941): "The cornerstone was laid, but the Court proceeded no further with its task of building upon it a concept of income. Each succeeding opinion paid its respects to the principle of realization which was the core of the Court's pronouncement in *Eisner* v. *Macomber*, but went on to a result which never matched the rigor of that pronouncement." Does the case that follows represent a retreat from the "rigor" of *Eisner* v. *Macomber?*

HELVERING v. BRUUN

Supreme Court of the U S, 1940

309 U.S. 461

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The controversy had its origin in the petitioner's assertion that the respondent realized taxable gain from the forfeiture of a leasehold, the tenant having erected

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* The opinion had been avidly awaited by the financial world, especially since a number of corporations had announced that stock dividends would be declared if held non-taxable. When Mr. Justice Pitney began to read his opinion, its import was misunderstood by a representative of Dow, Jones & Co., and a report that the Court had held the dividend taxable was sent out on the ticker. A collapse of stock prices, especially of those corporations which had previously been expected to declare stock dividends, resulted. After the false report was corrected, there was a rebound, sending prices up more than they had dropped. One observer blamed the incident on the fact that Supreme Court opinions are read "in a low or mumbling tone" and added. "I have heard that a committee of stockbrokers is going to investigate the occurrence." New York Times, March 9, 1920, p. 1.

a new building upon the premises. The court below held that no income had been realized. Inconsistency of the decisions on the subject led us to grant certiorari. . . .

The Board of Tax Appeals made no independent findings. The cause was submitted upon a stipulation of facts. From this it appears that on July 1, 1915, the respondent, as owner, leased a lot of land and the building thereon for a term of ninety-nine years.

The lease provided that the lessee might, at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

In 1929 the tenant demolished and removed the existing building and constructed a new one which had a useful life of not more than fifty years. July 1, 1933, the lease was cancelled for default in payment of rent and taxes and the respondent regained possession of the land and building.

The parties stipulated

that as at said date, July 1, 1933, the building which had been erected upon said premises by the lessee had a fair market value of $64,245.68 and that the unamortized cost of the old building, which was removed from the premises in 1929 to make way for the new building, was $12,811.43, thus leaving a net fair market value as at July 1, 1933, of $51,434.25, for the aforesaid new building erected upon the premises by the lessee.

On the basis of these facts, the petitioner determined that in 1933 the respondent realized a net gain of $51,434.25. The Board overruled his determination and the Circuit Court of Appeals affirmed the Board's decision.

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917 the Treasury ruled that the adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease. The ruling was incorporated in two succeeding editions of the Treasury Regulations. In 1919 the Circuit Court of Appeals for the Ninth Circuit held in *Miller* v. *Gearin*, 258 F. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned.

In 1935 the Circuit Court of Appeals for the Second Circuit decided in *Hewitt Realty Co.* v. *Commissioner*, 76 F.2d 880, 98 A.L.R. 1201, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detach-

able from the land, and if removed would be worthless except as bricks, iron, and mortar. It said, 76 F.2d at page 884:

> The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.

This decision invalidated the regulations then in force.

In 1938 this court decided *M. E. Blatt Co.* v. *United States*, 305 U.S. 267, 59 S. Ct. 186, 83 L. Ed. 167. There, in connection with the execution of a lease, landlord and tenant mutually agreed that each should make certain improvements to the demised premises and that those made by the tenant should become and remain the property of the landlord. The Commissioner valued the improvements as of the date they were made, allowed depreciation thereon to the termination of the leasehold, divided the depreciated value by the number of years the lease had to run, and found the landlord taxable for each year's aliquot portion thereof. His action was sustained by the Court of Claims. The judgment was reversed on the ground that the added value could not be considered rental accruing over the period of the lease; that the facts found by the Court of Claims did not support the conclusion of the Commissioner as to the value to be attributed to the improvements after a use throughout the term of the lease, and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act.

The circumstances of the instant case differentiate it from the Blatt and Hewitt cases; but the petitioner's contention that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled title, possession and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the *Miller* case and to the reasoning in the *Hewitt* case.

The respondent insists that the realty,—a capital asset at the date of the execution of the lease,—remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or treated as received in exchange for the improvements which were on the land at the date of the execution of the lease; that they are, therefore, in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner's disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment and may not, therefore, be taxed without apportionment.

We hold that the petitioner was right in assessing the gain as realized in 1933.

We might rest our decision upon the narrow issue presented by the terms of the stipulation. It does not appear what kind of a building was erected by the tenant or whether the building was readily removable from the land. It is not stated whether the difference in the value between the building removed and that erected in its place accurately reflects an increase in the value of land and building considered as a single estate in land. On the facts stipulated, without more, we

should not be warranted in holding that the presumption of the correctness of the Commissioner's determination has been overborne.

The respondent insists, however, that the stipulation was intended to assert that the sum of $51,434.25 was the measure of the resulting enhancement in value of the real estate at the date of the cancellation of the lease. The petitioner seems not to contest this view. Even upon this assumption we think that gain in the amount named was realized by the respondent in the year of repossession.

The respondent can not successfully contend that the definition of gross income in Sec. 22 (a) of the Revenue Act of 1932 is not broad enough to embrace the gain in question. That definition follows closely the Sixteenth Amendment. Essentially the respondent's position is that the Amendment does not permit the taxation of such gain without apportionment amongst the states. He relies upon what was said in *Hewitt Realty Co.* v. *Commissioner*, *supra*, and upon expressions found in the decisions of this court dealing with the taxability of stock dividends to the effect that gain derived from capital must be something of exchangeable value proceeding from property, severed from the capital, however invested or employed, and received by the recipient for his separate use, benefit, and disposal. He emphasizes the necessity that the gain be separate from the capital and separately disposable. These expressions, however, were used to clarify the distinction between an ordinary dividend and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder's interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here.

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

Judgment reversed.

THE CHIEF JUSTICE concurs in the result in view of the terms of the stipulation of facts.

MR. JUSTICE MCREYNOLDS took no part in the decision of this case.

Note

1. Would the result have been the same if the taxpayer had proved that in 1933 the land was worth less than its cost? What if the original building had not been razed but had been made more valuable by the tenant, either because he had renovated it or because by superior management he had attracted a better class of tenants?

2. Constitutional or not, a tax on the value of Mr. Bruun's building strikes unfairly because so much income is telescoped into a single year. Since the tax must be paid in

cash, the building may have to be sold by the taxpayer. The taxpayer could have avoided trouble by constructing the building himself and charging a higher annual rent to recoup its cost. If the Court's decision had been anticipated, the taxpayer might have preferred to renegotiate the rent downward, possibly to substantially less than the property's fair rental value, just to keep the tenant from throwing up the lease. These considerations led Congress in 1942 to enact what is now § 109 of the 1954 Code; see also § 1019. Note that "rent" is not excluded by § 109. I.T. 4009, 1950–1 C.B. 13, states that the fair market value of improvements that a lessee was to install "in lieu of rent" (to become the property of the lessor at the termination of the lease) was taxable to the lessor in the year of installation. See *Your Health Club, Inc.* v. *Commissioner*, 4 T.C. 385, 389 (1944). If the Bruun building had had a life expectancy longer than the lease, would part of its value have been taxable in 1929, when it was constructed, either under the court's decision, or under § 109 had it then been in effect? Note that § 109 excludes only such income as the lessor derives upon the *termination* of a lease Does this embrace only income arising from a premature termination of the lease, leaving fully taxable any income resulting from the fact that the building when constructed is expected to outlast the lease?

INAJA LAND CO. v. COMMISSIONER

Tax Court of the U S., 1947
9 T.C. 727

[In 1928 the taxpayer paid $61,000 for 1,236 acres of land on the banks of the Owens River, Mono County, California, together with certain water rights, for use as a private fishing club. The City of Los Angeles constructed a tunnel nearby in 1934 and commenced to divert polluted waters into the Owens River, and this action had a deleterious effect on the fishing on the taxpayer's preserve. In 1939 the City paid taxpayer $50,000 for a release of any liability for this diversion of foreign waters, and for an easement to continue to divert such waters, into the Owens River. In settling its claim against the City, the taxpayer incurred attorneys' fees and costs of $1,055.]

LEECH, Judge: The question presented is whether the net amount of $48,945 received by petitioner in the taxable year 1939 under a certain indenture constitutes taxable income under section 22(a), or is chargeable to capital account. The respondent contends: (a) That the $50,000, less $1,055 expenses incurred, which petitioner received from the city of Los Angeles under the indenture of August 11, 1939, represented compensation for loss of present and future income and consideration for release of many meritorious causes of action against the city, constituting ordinary income; and, (b) since petitioner has failed to allocate such sum between taxable and nontaxable income, it has not sustained its burden of showing error. Petitioner maintains that the language of the indenture and the circumstances leading up to its execution demonstrate that the consideration was paid for the easement granted to the city of Los Angeles and the consequent damage to its property rights; that the loss of past or future profits was not considered or involved, that the character of the easement rendered it impracticable to attempt to apportion a basis to the property affected: and, since the sum received is less than the basis of the entire property, taxation should be postponed until the final disposition of the property. . . .

Upon this record we have concluded that no part of the recovery was paid for

loss of profits, but was paid for the conveyance of a right of way and easements, and for damages to petitioner's land and its property rights as riparian owner. Hence, the respondent's contention has no merit. Capital recoveries in excess of cost do constitute taxable income. Petitioner has made no attempt to allocate a basis to that part of the property covered by the easements. It is conceded that all of petitioner's lands were not affected by the easements conveyed. Petitioner does not contest the rule that, where property is acquired for a lump sum and subsequently disposed of a portion at a time, there must be an allocation of the cost or other basis over the several units and gain or loss computed on the disposition of each part, except where apportionment would be wholly impracticable or impossible *Nathan Blum*, 5 T.C. 702, 709. Petitioner argues that it would be impracticable and impossible to apportion a definite basis to the easements here involved, since they could not be described by metes and bounds; that the flow of the water has changed and will change the course of the river, that the extent of the flood was and is not predictable; and that to date the city has not released the full measure of water to which it is entitled. In *Strother* v. *Commissioner*, 55 Fed.(2d) 626, the court says:

> . . . A taxpayer . . . should not be charged with gain on pure conjecture unsupported by any foundation of ascertainable fact See *Burnet* v *Logan*, 283 U.S. 404; 51 S.Ct. 550, 75 L.Ed. 1143.

This rule is approved in the recent case of *Raytheon Production Corporation* v. *Commissioner*, 1 T.C. 952, affd., 144 Fed.(2d) 110, certiorari denied, 323 U.S. 779. Apportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it can not be determined that petitioner has, in fact, realized gain in any amount. Applying the rule as above set out, no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of petitioner's cost basis. *Burnet* v. *Logan*, 283 U.S. 404.

Reviewed by the Court.

Decision will be entered for the petitioner.

Note

See Regs. 118, Sec. 39.22(a)-11, providing that upon the sale of sub-divided property, gain or loss shall be computed on the sale of each parcel, notwithstanding the taxpayer has not recouped his entire investment. This rule has been applied in a long line of cases, some of which are cited with approval in *Heiner* v. *Mellon*, 304 U.S. 271, at 275, n. 3 (1938). Suppose the taxpayer paid $10,000 for a tract of land, a block of securities, or a similar aggregate of property, and sells one-half for $7,500. Has he had a gain under *Eisner* v. *Macomber's* definition? What if he can prove that later in the year of sale the remaining property declined in value to $1,000?

Section C. Recovery of Capital

STANTON v. BALTIC MINING CO.

Supreme Court of the U.S., 1916
240 U.S. 103

[Under the 1913 income tax law, the taxpayer (a mining corporation) was taxed on its gross income less business expenses and losses and less 5% of the gross value of its production of ore. It attacked the constitutionality of the law on a number of grounds, only one of which is involved in the extract that follows. This ground was that the 5% allowance for depletion of its ore body was inadequate, since the ore in question had cost it more than the depletion allowance. This contention can be better understood if illustrated. Assume that a mining corporation pays $1,000,000 for a mine containing 1,000,000 tons of recoverable ore, and that the land will be totally worthless when this deposit has been mined. Assume further that in a given year 100,000 tons are mined and sold for $1,500,000. Under the 1913 law the taxpayer could deduct 5% of the sales price, or $75,000, for depletion, and the balance (less other expenses) would be taxable income. But, argued the taxpayer, the ore mined actually cost $100,000, since it paid $1,000,000 for a deposit of 1,000,000 tons, and therefore the depletion allowance is inadequate. (It should be noted that percentage depletion might exceed, instead of falling short of, any particular taxpayer's cost for his product. The importance of this possibility will be seen in Chapter 3, Sec. B(4).

MR. CHIEF JUSTICE WHITE delivered the opinion of the court: . . . The contention is that as the tax here imposed is not on the net product, but in a sense somewhat equivalent to a tax on the gross product of the working of the mine by the corporation, therefore the tax is not within the purview of the 16th Amendment, and consequently it must be treated as a direct tax on property because of its ownership, and as such void for want of apportionment. But, aside from the obvious error of the proposition, intrinsically considered, it manifestly disregards the fact that by previous ruling* it was settled that the provisions of the 16th Amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged, and being placed in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived,—that is, by testing the tax not by what it was, a tax on income, but by a mistaken theory deduced from the origin or source of the income taxed. Mark, of course, in saying this we are not here considering a tax not within the provisions of the 16th Amendment, that is, one in which the regulation of apportionment or the rule of uniformity is wholly negligible because the tax is one entirely beyond the scope of the taxing power of Congress, and where consequently no authority to impose a burden, either direct or indirect, exists. In other words, we are here dealing solely with the restriction imposed by the 16th Amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect, to

* Brushaber v. Union Pacific R. Co., 240 U.S. 1 (1916).

which it generically belongs, and putting it in the class of direct, to which it would not otherwise belong, in order to subject it to the regulation of apportionment. But it is said that although this be undoubtedly true as a general rule, the peculiarity of mining property and the exhaustion of the ore body which must result from working the mine cause the tax in a case like this, where an inadequate allowance by way of deduction is made for the exhaustion of the ore body, to be in the nature of things a tax on property because of its ownership, and therefore subject to apportionment. Not to so hold, it is urged, is as to mining property but to say that mere form controls, thus rendering in substance the command of the Constitution that taxation directly on property because of its ownership be apportioned, wholly illusory or futile. But this merely asserts a right to take the taxation of mining corporations out of the rule established by the 16th Amendment when there is no authority for so doing. It moreover rests upon the wholly fallacious assumption that, looked at from the point of view of substance, a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership, unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious assumption because, independently of the effect of the operation of the 16th Amendment, it was settled in *Stratton's Independence* v. *Howbert,* 231 U.S. 399, 58 L. ed. 285, 34 Sup. Ct. Rep. 136, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations. (Pp. 413 *et seq.*)

As it follows from what we have said that the contentions are in substance and effect controlled by the *Brushaber* Case, and, in so far as this may not be the case, are without merit, it results that, for the reasons stated in the opinion in that case and those expressed in this, the judgment must be and it is affirmed.

Mr. Justice McReynolds took no part in the consideration and decision of this case.

Note

What if by the time the mine has been exhausted the taxpayer has been taxed on more than the difference between its gross receipts and the sum of operating expenses plus the cost of the mine? Would the Court's reasoning sustain a federal "excise" tax on the receipt by Taxpayer Macomber of her stock dividends? See Magill, *Taxable Income* 335-373 (rev. ed. 1945). Does this case mean that taxpayers engaged in selling property need not be allowed a deduction for the cost of the property?

Doyle v. *Mitchell Bros. Co.,* 247 U.S. 179 (1918), involved a corporate taxpayer that sold, after the 1909 corporate income tax was enacted, timber that it had purchased before 1909. The taxpayer sought to offset against the gross receipts from the timber its *value* as of the beginning of 1909, and the Treasury took the position that only its *cost* could be used in computing taxable income. The Court held for the taxpayer, saying.

> There is no express provision that even allows a merchant to deduct the cost of the goods that he sells. Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. . . . In order to determine whether there has been gain or loss, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration . . . It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact

should be deducted from gross receipts in the process of ascertaining gross income, or should be deducted from gross income in the form of a depreciation account in the process of determining net income. In either case the object is to distinguish capital previously existing from income taxable under the act. There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act.

See Magill, *Taxable Income* (rev. ed. 1945) 347–368, discussing the *Stanton* and *Mitchell Bros. Co.* cases, which states (at 351):

. . . the *Stanton* case is not a sufficient basis for the generality that gross *receipts* (as distinguished from gross income) can be taxed as income under the [Sixteenth] amendment. Rather, the *Stanton* case and its successors are authority for the proposition that, in view of the fact that the extent of a mineral deposit is an unknown quantity, Congress may impose limitations on the depletion deduction which it could not place upon the deduction for the cost of other goods sold.

SULLENGER v. COMMISSIONER

Tax Court of the U.S., 1948
11 T.C. 1076

MURDOCK, Judge: . . . .

The petitioner paid to wholesale meat packing firms during the taxable years, for meats purchased from them, amounts in excess of the O.P.A. prices in effect at the time of the purchases. The petitioner then sold the meat and the income from those sales is being taxed. The Commissioner, in determining the deficiencies, failed to recognize the excess over O.P.A. prices as cost of goods sold.

The respondent argues that the amounts paid in excess of the O.P.A. prices were "not truly a part of cost of goods sold" but were "in reality nothing but a 'bribe' to the various packing firms or amounts paid to them illegally to induce them to sell the goods to petitioner at the ceiling price." He then argues that the amounts must be considered from the standpoint of deductions, deductions are a matter of grace and not of right, to allow these amounts as deductions would be contrary to public policy, and, therefore, the determination of the Commissioner must be affirmed.

The trouble with his argument is that its major premise is unsound. The amounts in question were actually, as the stipulation shows, a part of the cost of goods sold and are not being claimed by this petitioner as a deduction under § 23. Section 23 [§§ 162-175, '54 Code] makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory. The income from a business which is wholly illegal was held subject to income tax in *United States* v. *Sullivan*, 274 U.S. 259. Nevertheless, it was necessary to determine what that income was, and the cost of an illegal purchase of liquor was subtracted from proceeds of the illegal sale of the liquor in order to arrive at the gain from the illegal transactions which were subjected to income tax in that case. This is not a case of penalties provided for violation of the O.P.A. regulations. See the Emergency Price Control Act of

1942 (Title 50, App. U.S.C.A., sec. 901 *et seq.*). No authority has been cited for denying to this taxpayer the cost of goods sold in computing his profit, which profit alone is gross income for income tax purposes. It is unnecessary to discuss cases involving deductions, since this case does not involve any deduction. The point in controversy is decided for the petitioners.

Reviewed by the Court.

Decisions will be entered under Rule 50.

DISNEY, J., *dissenting.*

I can not agree with the conclusion that the cost of goods above the ceiling price set by law should be subtracted from gross receipts in order to determine gross income. No such question was considered or conclusion reached in *United States* v. *Sullivan*, 274 U.S. 259, relied on in the majority opinion. There only two points were considered: (a) Is the income from illegal business taxable? (b) Did the Fifth Amendment protect the taxpayer from making a return? As indication of how narrow the Court's field of examination was, we quote the last paragraph:

> It is urged that if a return were made the defendant would be entitled to deduct illegal expenses such as bribery. This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it.

This problem has received attention in I.T. 3724 and I.T. 3811. Though not cited as authority, they do indicate study of the question here presented. In I.T. 3811, Section 117(j) [§ 1231 of the 1954 Code] (as to capital gains and losses) was refused application to that part of the gain from sales in excess of the ceiling prices established by the Office of Price Administration, and the gain in excess of ceiling price was held to be ordinary income. In I.T. 3724 precisely the instant situation was involved, and amounts paid in "black market" operations in excess of ceiling prices were held not allowable either as a part of cost of goods sold, or as business expense deduction in computing Federal income tax. The I.T. quotes the Emergency Price Control Act of 1942, in pertinent part, as follows: "It shall be unlawful, . . . to sell or deliver any commodity, or in the course of trade or business to buy or receive any commodity, . . . in violation of any . . . price schedule . . ." set by the law. Thus, both the buying and selling by the petitioner were illegal, if above ceiling prices. Though *Steinberg* v. *United States*, 14 Fed.(2d) 564, holds that ordinary and necessary expenses may be deducted in arriving at profits of an illegal business, a long line of cases establishes that "ordinary and necessary" does not include illegal expenses contrary to public policy. Such cases are assembled in I.T. 3724, *supra;* and there it is concluded, referring to payments in excess of ceiling prices, that "The excess payments are not legitimately to be classified as a part of the cost of goods sold, and public policy decrees that no tax advantage may be derived from such expenditures." I am unable to distinguish the expenditure here involved, so far as here concerned, from expenses found, on grounds of public policy, not to be ordinary and necessary; and any suggestion that the petitioners' capital went into the goods purchased is subject to the same conclusion, that public policy forbids the allowance. The majority view stultifies the law. In effect it means that, though for purposes of preventing inflation the O.P.A. law is effective, the law of income taxation can not recognize it, regardless of the sound public policy involved. The law

of income taxation is thus made to uphold the inflation the O.P.A. law seeks to prevent. Had the petitioner, violating the O.P.A. law in purchasing above price ceilings, taken, on the contrary, a loss, it would not be allowable. *Lawrence A. Wagner*, 30 B.T.A. 1099, and cases following it. On the broad question of public policy here involved, I think there is no sound reason to distinguish the present situation from those above covered. The definition of income is broad and inclusive, therefore illegality of business can not serve as a shield; but it does not follow that every expense incurred, however illegal in its nature, may serve to diminish the receipts. Would expenses of bribery be allowed because an integral part of an illicit business? If not, why exclude from the same category an amount expended which is equally illegal? The amount above ceiling price is affirmatively and positively illegally expended, under the O.P.A. law. It was not necessary, in order to stay in business, to pay the prices in excess of the ceiling set (under any application of *Commissioner* v. *Heininger*, 320 U.S. 467), so far as I see indicated in this case. I think the law here administered must be consistent with the statute passed against inflation, and not contribute thereto despite that law. The whole income tax set-up and administration is a creature of constitution and law. Why an expenditure in contravention of law, and of public policy, should be permitted subtraction and thus affect such taxation, is difficult to understand. Is the law of income tax thus to serve as an exception to the O.P.A. law and its objectives? I think that purchases, like other expenses, to secure effect in reducing what would otherwise be taxed, must be within the law. I respectfully dissent.

Note

1. In a number of other cases, the same result was reached on the ground that Congress did not *intend* to disallow such over-ceiling payments in calculating taxable income. *Commissioner* v. *Weisman*, 197 F.2d 221 (1st Cir. 1952); and cases cited in I.T. 4104, 52- 2 C.B. 71, where the Bureau announced its acquiescence in the *Sullenger* case. Chief Judge Magruder, concurring in the *Weisman* case, said

> But I hope the court's opinion will not give the impression that there is any serious doubt of the constitutional power of Congress to exclude from the offset so much of the cost of the goods sold as represented payment by the taxpayer in excess of the applicable ceiling price.
>
> It may be that a merchant's gross receipts from sales of a commodity represent a return of capital, and not gross income, at least to the extent of the cost to the merchant of the goods sold. In this view, a tax by Congress on the merchant's gross receipts, as such, would not be a tax on income, sustainable under the Sixteenth Amendment. The question then would be whether such a tax fell within the general taxing power of Congress conferred by Article I, § 8, of the Constitution, or whether it would be deemed a "direct" tax which had to be laid in proportion to the population, as provided in Article I, § 9.

Judge Magruder went on to argue that as a penalty for violating the price control program, Congress could have provided for the disallowance of over-ceiling payments for goods sold:

> It seems to me clear that Congress would have constitutional power to impose such a sanction, to be applied in the administration of the tax laws, whether or not Congress would have power to impose a general tax on gross receipts, applicable to the law-abiding as well as to law violators. (197 F.2d 221, 224-226.)

The Defense Production Act of 1950 (unlike its World War II counterpart, under which the *Sullenger* case was decided) expressly authorizes a disallowance of over-ceiling payments in calculating gain on the sale of property. I.T. 4105, 52-2 C.B. 93.

2. The World War II Price Control Act did authorize the President to prescribe the extent to which over-ceiling *wage* and *salary* payments should be disregarded "in determining the costs or expenses of any employer," and pursuant to this authorization the President issued an Executive Order providing that such payments should not be allowed as deductions under the Revenue Code. In *Weather-Seal Mfg. Co.* v. *Commissioner,* 16 T.C. 1312 (1951), aff'd. w.o.op., 199 F.2d 376 (6th Cir. 1952), this disallowance was held to be constitutional, despite the fact that the disallowed wage payments were, pursuant to customary accounting practice, part of the taxpayer's "cost of goods sold." See also *N. A Woodworth Co.* v *Kavanaugh,* 102 F. Supp. 9 (E.D. Mich. 1952), aff'd. w.o.op , 202 F.2d 154 (6th Cir. 1953).

3. Aside from the constitutional issue, illegal payments pose certain statutory questions. These are considered *infra,* pp. 245-250.

Section D. Increase in Net Worth

DALLAS TRANSFER & TERMINAL WAREHOUSE CO. v. COMMISSIONER

U.S. Court of Appeals, Fifth Circuit, 1934
70 F.2d 95

[The taxpayer was the lessee of part of a warehouse, the rental for which was $7,000 per month In September, 1928, it owed the lessor $107,880 77 in back rent. In full settlement of this debt, taxpayer conveyed to the lessor certain real estate, its equity in which was worth $17,507.20, and the lessor charged off as a bad debt the difference of $90,373.59. The Commissioner asserted a deficiency against the taxpayer, based on the theory that it had realized taxable gain in the amount of $93,367.35—the difference between the debt, $107,880.77, and the cost (less depreciation already taken) to it of the property conveyed in settlement, $14,513.42.

[At the time of the settlement, taxpayer was insolvent. It had assets of about $152,500, liabilities to creditors (including its landlord) of about $179,000, and a common stock liability of $200,000. Thus its deficit was about $226,500, and its assets were about $26,500 less than its liabilities to creditors.]

Before Bryan, Sibley, and Walker, Circuit Judges.

Walker, Circuit Judge. . . .

It is plain that in September, 1928, the above-mentioned lease had resulted in burdening the petitioner with a debt of $107,880.77 to its lessor and rendering the petitioner insolvent, and that the lessor, for the purpose of enabling the petitioner to remain in business and to have a chance to pay the reduced future rental agreed upon, and also for the purpose of keeping the lessor's 9-story building from being vacant and unprofitable, accepted in part payment on the debt owing to it petitioner's equity in the Alamo street property at the appraised value of that equity, $17,507.20, and canceled the balance of that debt, charging it off as worthless. The transaction was not in form or substance a sale for $107,880.77 of

property which had an appraised value of $17,507.20. In effect the transaction was similar to what occurs in an insolvency or bankruptcy proceeding when, upon a debtor surrendering, for the benefit of his creditors, property insufficient in value to pay his debts, he is discharged from liability for his debts. This does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. *Eisner* v. *Macomber*, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521, 9 A.L.R. 1570, *Merchants' L. & T. Co.* v. *Smietanka*, 255 U.S. 509, 519, 41 S. Ct. 386, 65 L. Ed. 751, 15 A.L.R. 1305. It hardly would be contended that a discharged insolvent or bankrupt receives taxable income in the amount by which his provable debts exceed the value of his surrendered assets. The income tax statute does not purport to treat as income what did not come within the meaning of that word before the statute was enacted The instant case is substantially different from the case of *United States* v. *Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131, which was principally relied on by the Board of Tax Appeals for support of its conclusion that the canceled indebtedness in excess of the depreciated cost of the Alamo street property constituted income to the petitioner for the year 1928. In the last-mentioned case a corporation issued its bonds at par and in the same year repurchased some of them at less than par. The taxpayer's assets having been increased by the cash received for the bonds, by the repurchase of some of those bonds at less than par the taxpayer, to the extent of the difference between what is received for those bonds and what it paid in repurchasing them, had an asset which had ceased to be offset by any liability, with a result that after that transaction the taxpayer had greater assets than it had before. The decision (which was followed in *Helvering, Commissioner* v. *American Chicle Co.*, 291 U.S. 426, 54 S. Ct. 460, 78 L. Ed. 891) that the increase in clear assets so brought about constituted taxable income is not applicable to the facts of the instant case, as the cancellation of the respondent's past due debt to its lessor did not have the effect of making the respondent's assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income. *Commissioner of Internal Revenue* v. *Rail Joint Co.* (C.C.A.) 61 F.(2d) 751, 752; *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886, *Burnet* v. *John F. Campbell Co.*, 60 App. D.C. 197, 50 F.(2d) 487.

The decision that the petitioner acquired taxable income as a result of the cancellation of its debt to its lessor was erroneous. The petition is granted, and the order under review is reversed.

Note

1. Note the statement that the taxpayer in the *Kirby Lumber Co.* case "had greater assets than it had before." Were its assets immediately after the repurchase of the bonds greater than its assets immediately before the repurchase? Or does the court mean only that it took in more on issuing the bonds than it paid out on retiring them? This would

be equally true of an insolvent debtor who had borrowed money and settled with the lender for less than the face amount of the loan.

2. Apparently an insolvent taxpayer must report other kinds of income, such as compensation for personal services. See *Parkford* v. *Commissioner*, 133 F.2d 249 (9th Cir. 1943), cert. den., 319 U S. 741. Note that compensation paid to an insolvent taxpayer, like the partial cancellation of the *Dallas Warehouse Company's* indebtedness, decreases his deficit. Should it make any difference for tax purposes that this decrease in his deficit is the result of an increase in his assets rather than of a decrease in his liabilities? The result of either event is to bring the taxpayer closer to solvency and to increase the percentage of their claims that remaining creditors may collect

3. In *Lakeland Grocery Co.* v. *Commissioner*, 36 B.T.A. 289 (1937), a divided court held that where a partial cancellation of an insolvent taxpayer's debt not only wiped out its deficit but restored it to solvency, it realized income to the amount of its net worth after the cancellation. The majority, apparently erroneously, thought that these facts had not been present in the *Dallas Transfer & Terminal Warehouse Co.* case.

4. Certain other aspects of the cancellation of a taxpayer's indebtedness are taken up *infra*, p. 116.

Section E. Recoveries for Personal and Business Injuries

SOL. OP. 132

Bureau of Internal Revenue, 1922

I-1 C.B. 92

The question presented is whether the following receipts constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder: (1) Damages for alienation of affections; (2) damages for slander or libel of personal character; and (3) money received by a parent in consideration of the surrender of his right to the custody of his minor child.

All of these items relate to personal or family rights, not property rights, and accordingly may be treated together. Nor is there a material distinction between payment under an agreement of the parties and payment pursuant to a judgment of a court.

It is held in Solicitor's Memorandum 957 that money recovered as damages in libel proceedings is subject to income tax, and in Solicitor's Memorandum 1384, that damages for alienation of a wife's affections are not exempt from income tax under section 213(b) 6 of the Revenue Act of 1918. Both of these rulings, however, were made prior to the decision of the Supreme Court in *Eisner* v. *Macomber* (252 U.S. 189). Solicitor's Memorandum 1384 correctly held that the exemption contained in section 213(b) 6 of the Revenue Act of 1918 does not include damages for alienation of affections, but the question is really more fundamental, namely, whether such damages received by a lawyer for libel of his professional reputation constitute income. Business libel may be distinguished from ordinary defamation of character and is not here under consideration. The ruling in Solicitor's Memorandum 957, however, was not limited but apparently applied to libel generally.

In *Stratton's Independence* v. *Howbert* (231 U.S. 399) and in *Eisner* v. *Macomber* (252 U.S. 189, 207), the Supreme Court defined income as "the gain

derived from capital, from labor, or from both combined. . . ." In other words, without gain of some sort no income within the meaning of the sixteenth amendment can be said to be realized.

In the light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable. While a jury endeavors roughly to compute the amount of damage inflicted, in the very nature of things there can be no correct estimate of the money value of the invaded rights. The rights on the one hand and the money on the other are incomparable things which can not be placed on opposite sides of an equation. If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the Government can not tax him on any portion of the sum received. This also applies to money received in consideration of the surrender of the custody of a minor child. Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered.

In the cases cited above, in *Lynch* v. *Turrish* (247 U.S. 221), and in other cases, the Supreme Court has repeatedly held that gross income does not include everything that comes in. In *Gould* v. *Gould* (245 U.S. 151) it was held that alimony is not income. Before the enactment of the Revenue Act of 1918, which specifically exempted from gross income damages for personal injuries, it was held that damages for personal injuries due to accident do not constitute income. T.D. 2747 (not published in Bulletin service). Much less should damages for alienation of affections or defamation of personal character be held to constitute income. Slander or libel affecting business reputation or property rights, however, are not considered in this opinion.

I am of the opinion, therefore, that money received, whether under agreement of the parties or pursuant to judgment of a court, on account of damages for alienation of affections or defamation of personal character or in consideration of the surrender of the custody of a minor child, does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder.

Solicitor's Memorandum 957 is modified to accord with this opinion, and Solicitor's Memorandum 1384 is revoked.

Note

1. In 1923 the Bureau of Internal Revenue announced that damages received for breach of a promise to marry were not taxable, on the ground that "a promise to marry is a personal right not susceptible of any appraisal in relation to market values and that damages or payment in compromise of the invasion of such right does not constitute taxable income" I.T. 1804, II-2 C.B. 61, 62 (1923). Later this ruling was revoked. I.T. 2170, IV-1 C.B. 28 (1925). The revocation was apparently based on a distinction between payments for relinquishing contract rights and payments to redress torts:

> As a general rule, rights acquired . . . through the exercise of one's physical or mental faculties, when converted into cash or its equivalent, constitute income to the recipient to the full amount received. . . .

> The situation presented by Solicitor's Opinion 132 is quite different. The payment involved was attributable to a tort. A personal injury was inflicted, an inherent right was invaded, a right in rem given by the law against the whole world. The holding is merely that payments to compensate a taxpayer for that of which he has been deprived by the invasion of such an inherent right do not constitute "gain" to him, and therefore no income results. . . .
>
> Solicitor's Opinion 132 is distinguishable in that the damages received by the taxpayer in that case were on account of a past injury suffered through an invasion of an inherent, personal right, a right which is granted by law to all persons in similar circumstances, as distinguished from one which arises out of a contract of which the benefits are due, in the last analysis, to the exercise of the mental faculties. S.M. 2042, IV-1 C.B 26, 27-28 (1925).

In *McDonald* v. *Commissioner*, 9 B.T A 1340 (1928), damages for breach of contract to marry were held non-taxable on the authority of the *Hawkins* case, *infra*, p. 74.

2. In *Ehrlich* v. *Higgins*, 52 F. Supp. 805 (S.D.N.Y. 1943), the widow of Paul Ehrlich (the discoverer of "Salvarsan") asserted that $42,500 paid to her by Warner Bros. Pictures, Inc., which was producing a motion picture based on her husband's life, was not taxable because the payment was intended as damages for invasion of her right of privacy. The Court found that the payment was made primarily for the use of certain letters, notes, and similar material, and not as compensation for an invasion of privacy. But the Court went on (52 F. Supp. 805, 808–09) to make this comment on Solicitor's Opinion 132·

> It seems probable that if a woman were paid a consideration in monthly payments for a voluntary release of her fiance from a promise to marry, she would be paid for giving up a legal right and, therefore, the foundation would be the same as in all other contracts.
>
> The only suggestion in the literature on the subject that a contrary result might be reached appears in an opinion of the Solicitor of Internal Revenue (Cumulative Bulletin I-1, 92), where it is said that money received by a parent in consideration of the surrender of his right to the custody of his minor child stands on the same basis as damages for alienation of affections and damages for personal libel or slander. This notion permits no distinction between damages for wrongs committed and payments for giving up any legal right. The parent could contract for the labor of the child and the payments would not be exempt. The writer of the opinion arrived at the conclusion by the emotional avenue, saying that· "Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered." The real difference between the two cases is that in one there is consummated damage to a personal right which is compensated, and in the other a simple contract, whereby a right presently possessed is resigned for a future period for money.
>
> Much more accurate are the cases which recognize the fact that contractual surrender of any legal right for stated payments produces income to the recipient. So it has been held that payments not to work for another or compete in business are taxable as income. So, also, the sales of good will, together with tangible assets of a business are subject to the laws regulating taxes.
>
> If the contrary principle were recognized, there would be suits for refunds by each of the actresses in Hollywood upon the ground that, although each is paid a salary for personal services in the production of films, the real value which the producer obtains from the contract is the right to produce before the public the representation so made, and that the payments are really damages in prospect for the violation of the right of personal privacy. The revenue laws do not contain any such loophole.

HAWKINS v. COMMISSIONER

Board of Tax Appeals, 1927
6 B.T.A. 1023

Findings of Fact

Petitioner, an individual residing in San Francisco, Calif., was an industrial engineer engaged in corporate management. Prior to March 23, 1918, he had for some time been president of the C. L. Best Gas Traction Co. On that date he was removed from office by the directors, and thereafter certain of the officers of the corporation made and published defamatory statements about him. He instructed his attorney to file against the corporation and the individual officers a suit in libel and slander demanding $1,000,000 damages for injury to his reputation, business and health. Two of the officers of the corporation had already filed suits against the petitioner, one for libel and one for money owed by reason of an alleged misuse of corporate funds during petitioner's term of office. Before petitioner's attorney began the suit in his behalf a settlement of petitioner's claims was orally negotiated and made. By this settlement the petitioner received, on or about January 15, 1919, $100,000 in cash and the corporation's note for $12,500. He also received $306.41 as interest. In further consideration under the settlement agreement the two suits which had been begun against him were dismissed.

Opinion

Sternhagen: The consideration of the question whether the damages received for libel and slander are taxable as income must proceed not so much according to the refinements of economists, *Lynch* v. *Turrish,* 247 U.S. 221; *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U.S. 509, as according to such decisions of the Supreme Court as mark the course. That stock dividends, *Eisner* v. *Macomber,* 252 U.S. 189; stock rights, *Miles* v. *Safe Deposit & Trust Co.,* 259 U.S. 247; subsidies, *Edwards* v. *Cuba R.R. Co.,* 268 U.S. 628; or savings, under certain circumstances, on the liquidation of indebtedness through a drop in foreign exchange, *Bowers* v. *Kerbaugh-Empire Co.,* 271 U.S. 170, have been held not to be income; while the gain from capital sales, *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U.S. 509; *Goodrich* v. *Edwards,* 255 U.S. 527; dividends in specie, *Peabody* v. *Eisner,* 247 U.S. 347; *United States* v. *Phellis,* 257 U.S. 156; and periodic payments under a will from a trust fund in which the payee has no direct interest, *Irwin* v. *Gavit,* 268 U.S. 161, have been held to be income, narrows the course but little, because the nature of the situations which gave rise to those decisions is inherently different from the question here.

The petitioner cites some of these decisions for the statement therein contained that income is the gain derived from capital or labor or both, including profit from the conversion of capital assets, and that nothing else answers the description. Whether this description of income is to be regarded as exclusive of everything not clearly within its terms, so that both the Sixteenth Amendment and the statute (which is said to be the fullest exercise of the constitutional power, *Eisner* v. *Macomber,* 252 U.S. 189, *Irwin* v. *Gavit,* 268 U.S. 161) are forever to be limited by a judicial definition, may still be doubtful, for the Supreme Court is not

in the habit of defining words abstractly, but only for the purpose of determining whether the matter then under consideration comes within their fair intendment. The court has itself said that the word is not a crystal,* *Towne* v. *Eisner*, 245 U.S. 418, and it is conceivable that since the income tax is primarily an application of the idea of measuring taxes by financial ability to pay, as indicated by the net accretions to one's economic wealth during the year, there may be cases in which taxable income will be judicially found although outside the precise scope of the description already given.

This we think is not such a case, but is on the other hand one which in no event involves income. So far as the evidence shows, the amount which petitioner received was wholly by way of general damages for the personal injury suffered by reason of the defamatory statements made. It was compensation for injury to his personal reputation for integrity and fair dealing, including, as the record indicates, the injury to his health. This is the ordinary basis for compensatory damages, *Childers* v. *San Jose Mercury Printing & Publishing Co.*, 105 Cal. 284; 38 Pac. 903. No suggestion is made that there was special damage paid or that any was asserted or that punitive or exemplary damages were claimed or paid, and we need not consider the law as to them. Here there is only the compensation which the law sanctions as the only remedy which has thus far been devised for an injury which in its nature is wholly personal and nonpecuniary. Even to the economist, character or reputation or other strictly personal attributes are not capital or otherwise measurable in terms of wealth, notwithstanding that all will recognize them as important factors of economic success. They are not property or goods. Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.

There is some support for this reasoning in the dictum of the Chief Justice in *United States* v. *Supplee-Biddle Hardware Co.*, 265 U.S. 189, as to the insurance received by a corporation upon the life of its officer:

> . . . Life insurance in such a case is like that of fire and marine insurance, a contract of indemnity. *Central Bank of Washington* v. *Hume*, 128 U S 195. The benefit to be gained by death has no periodicity. It is a substitution of money value for something permanently lost, either in a house, a ship, or a life. Assuming without deciding that Congress could call the proceeds of such indemnity, income, and validly tax it as such, we think that in view of the popular conception of the life insurance as resulting in a single addition of a total sum to the resources of the beneficiary, and not in a periodical return, such a purpose on its part should be express, as it certainly is not here

If compensation for the loss of a life is not taxable as income unless expressly provided, compensation for the injury to personal reputation should similarly require an express provision.

Note

1. The Bureau has ruled that an award paid by the Mixed Claim Commission of the United States and Germany for the death of a passenger on the *Lusitania* is not taxable:

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* "But it is not necessarily true that income means the same thing in the Constitution and the Act. A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." Mr. Justice Holmes, in Towne v. Eisner, 245 U S. 418, 425 (1918). [Ed.]

> An award paid for the loss of a life is compensation for the loss, and as such is not embraced in the general concept of the term "income" . . .
>
> It is held, therefore, that inasmuch as the award of 40x dollars payable to A is not expressly taxable under the provisions of the Revenue Act of 1926 [no different in this respect from any later Revenue Act], and is not embraced in the general concept of the term "income," the amount of the award is not taxable to A. I.T. 2420, VII–2 C.B. 123, 124 (1928).

Note that since the award was designed "to restore A to substantially the same financial and economic status as she possessed prior to the death of her husband," it took the place of income that would have been taxed had he survived. Has the tortfeasor wronged the Treasury as well as his victim's family so that he should pay accordingly? See Wurzel, "The Origin and Development of Quo Minus," 49 *Yale L. J.* 39 (1939). If the award *were* taxable, the position of the tortfeasor would not be an enviable one. To give a widow $75,000 free and clear, for example, would require a payment by the tortfeasor of more than $600,000 (at present rates and assuming the widow had no other income).

Do juries understand that their awards in death cases are not taxable? In *Dempsey* v. *Thompson*, 363 Mo. 339, 251 S.W.2d 42 (1952), it was held that the jury should be instructed that any award it made would not be taxable. On the other hand, the court held that although the recovery was to compensate for loss of future earnings, the defendant could not go into the extent to which such earnings would have been reduced by income taxes had the decedent not been injured, on the ground that a reasonably accurate estimate of future taxes is not possible. See also *Hall* v. *Chicago & N.W. Ry. Co.*, 349 Ill App. 175, 110 N.E.2d 654 (1953); Comment, Propriety of Comment on Non-Taxability of Personal Injury Verdicts, 21 *U. of Chi. L. Rev.* 156 (1953).

2. Section 104 specifically exempts damages on account of personal injuries or sickness and will be examined *infra*, p. 143.

FARMERS' & MERCHANTS' BANK v. COMMISSIONER

U.S. Court of Appeals Sixth Circuit, 1932

59 F.2d 912

Before MOORMAN, HICKS, and HICKENLOOPER, Circuit Judges.

HICKS, Circuit Judge.

Petitioner, a corporation, was engaged in the banking business at Catlettsburg, Ky., and within the district of the Federal Reserve Bank of Cleveland, Ohio. It was the custom of petitioner to make a charge for the collection of checks on foreign banks and of checks drawn on it and sent from other banks. Petitioner was not a member of the Federal Reserve System so that checks drawn on it instead of being cleared through the Reserve Bank were sent direct to petitioner by the holding bank and paid by drafts on Cincinnati or New York.

In 1920 the Reserve Bank demanded that petitioner should clear checks at par. This demand was refused, and thereupon the Reserve Bank notified its members that it would collect without charge all checks sent to it and drawn on petitioner. Its method was to employ agents who would appear daily at the bank with these checks and demand payment thereof in cash. This practice was followed about eighteen months. For a greater portion of the time these collections were effected in such an unusual and unbusinesslike manner as to attract unfavorable public comment, and petitioner claimed that it was thereby annoyed, embarrassed, and

interfered with in the conduct of its affairs. Subsequently petitioner brought an action against the Reserve Bank for damages alleged to have been sustained by reason of these tactics. In its petition it set out particularly that, by reason of the wrongful conduct of the Reserve Bank, it had been forced to procure and keep in its vaults and with its correspondents unusually large amounts of money; that it had lost the earning power of a great deal of money; that it had lost deposits and depositors, and had failed to gain new ones; that it had been unable to grow, and to develop new business; and that it had been permanently injured in its reputation, standing, growth, and prosperity. The petition also included a claim for exemplary damages based upon a charge that the conduct of the Reserve Bank was malicious.

This action was compromised in 1925 and the Reserve Bank paid $18,750.00 in full settlement. The expense of the suit being deducted the net amount received by petitioner was reduced to $13,792.96. Respondent conceived that this fund represented earnings for the year 1925 and included it in petitioner's net income for that year. The Board of Tax Appeals sustained the respondent. It decided that at least some portion thereof represented earnings and that petitioner had failed to show what portion did not.

We cannot assent.

The fund involved must be considered in the light of the claim from which it was realized and which is reflected in the petition filed in its action against the Reserve Bank. We find nothing therein to indicate, with the certainty required in the statement of a cause of action, that petitioner sought reparation for profits which petitioner's misconduct prevented it from earning in 1925. Charles E. Rous, petitioner's cashier, testified before the Board that the loss of such earnings could not be definitely determined and this probably furnishes the explanation for the failure definitely to demand it. Petitioner not only did not insist upon the restoration of anticipated profits as a matter of fact, but based its claim for damages upon an alleged tortious injury to the good will of its business, and we can see no legal distinction between compensation for destruction of or damage to incorporeal or intangible property, such as good will, and similar compensation for damage to tangible property. Compare *Harris & Co.* v. *Lucas* (C.C.A.) 48 F.(2d) 187, syl. 5.

We think that the gravamen of petitioner's action against the Reserve Bank was the injury inflicted to its banking business generally, and that the true measure of damages was compensation to be determined by ascertaining how much less valuable its business was by reason of the wrongful acts of the Reserve Bank. See *Yates* v. *Whyel Coke Co.*, 221 F. 603, 607 (C.C.A. 6); *Central Coal & Coke Co.* v. *Hartman*, 111 F. 96, 99 (C.C.A. 8). Injury to its business of course means injury to its financial standing, credit, reputation, good will, capital, and other possible elements. Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery. We think that, if petitioner's case had proceeded to a verdict, the law would not have awarded to it what it might have expected to gain but only that which it had actually lost. We are not justified in reading an element into the compromise which was not therein distinctly recognized in fact and would not have been recognized in law. We think therefore that there is no

logical basis upon which petitioner could be charged with gain. See *Strother* v. *Commissioner*, 55 F.(2d) 626, 633 (C.C.A. 4). One may be recompensed for an injury but it is a rare case in which one should have a profit out of it.

The order of the Board of Tax Appeals is reversed.

RAYTHEON PRODUCTION CORPORATION *v.* COMMISSIONER

U.S. Court of Appeals, First Circuit, 1944

144 F.2d 110, cert. den., 323 U.S. 779

Before MAGRUDER, MAHONEY, and WOODBURY, Circuit Judges.

MAHONEY, Circuit Judge.

This case presents the question whether an amount received by the taxpayer in compromise settlement of a suit for damages under the Federal Anti-Trust Laws, 15 U.S.C.A. § 1 *et seq.*, is a non-taxable return of capital or income. . . .

The original Ratheon Company was a pioneer manufacturer of a rectifying tube which made possible the operation of a radio receiving set on alternating current instead of on batteries. In 1926 its profits were about $450,000; in 1927 about $150,000; and in 1928, $10,000. The Radio Corporation of America had many patents covering radio circuits and claimed control over almost all of the practical circuits. Cross-licensing agreements had been made among several companies including R.C.A., General Electric Company, Westinghouse, and American Telephone & Telegraph Company. R.C.A. had developed a competitive tube which produced the same type of rectification as the Raytheon tube. Early in 1927, R.C.A. began to license manufacturers of radio sets and in the license agreement it incorporated "Clause 9," which provided that the licensee was required to buy its tubes from R.C.A. In 1928 practically all manufacturers were operating under R.C.A. licenses. As a consequence of this restriction, Raytheon was left with only replacement sales, which soon disappeared. . . . On December 14, 1931, the petitioner caused its predecessor, Raytheon, to bring suit against R.C.A. in the District Court of Massachusetts alleging that the plaintiff had by 1926 created and then possessed a large and valuable good will in interstate commerce in rectifying tubes for radios and had a large and profitable established business therein so that the net profit for the year 1926 was $454,935; that the business had an established prospect of large increases and that the business and good will thereof was of a value exceeding $3,000,000; that by the beginning of 1927 the plaintiff was doing approximately 80% of the business of rectifying tubes of the entire United States; that the defendant conspired to destroy the business of the plaintiff and others by a monopoly of such business and did suppress and destroy the existing companies; that the manufacturers of radio sets and others ceased to purchase tubes from the plaintiffs; that by the end of 1927 the conspiracy had completely destroyed the profitable business and that by the early part of 1928 the tube business of the plaintiff and its property and good will had been totally destroyed at a time when it had a present value in excess of $3,000,000, and thereby the plaintiff was injured in its business and property in a sum in excess of $3,000,000. . . .

. . . R.C.A. and the petitioner finally agreed on the payment by R.C.A. of $410,000 in settlement of the anti-trust action. . . .

Damages recovered in an anti-trust action are not necessarily non-taxable as a

return of capital. As in other types of tort damage suits, recoveries which represent a reimbursement for lost profits are income. *Swastika Oil & Gas Co.* v. *Commissioner*, 6 Cir., 1941, 123 F.2d 382, certiorari denied 1943, 317 U.S. 639, 63 S. Ct. 30, 87 L. Ed. 515, *H. Liebes & Co.* v. *Commissioner*, 9 Cir., 1937, 90 F.2d 932; *Sternberg* v. *Commissioner*, 1935, 32 B.T.A. 1039. The reasoning is that since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner.

Damages for violation of the anti-trust acts are treated as ordinary income where they represent compensation for loss of profits. *Commercial Electrical Supply Co.* v. *Commissioner*, 1927, 8 B.T.A. 986; see *Park* v. *Gilligan*, D.C.S.D. Ohio 1921, 293 F. 129, 130.

The test is not whether the action was one in tort or contract but rather the question to be asked is "In lieu of what were the damages awarded?" *Farmers' & Merchants' Bank* v. *Commissioner*, 6 Cir., 1932, 59 F.2d 912, *Swastika Oil & Gas Co.* v. *Commissioner*, *supra*; *Central R. Co. of New Jersey* v. *Commissioner*, 3 Cir., 1935, 79 F.2d 697, 101 A.L.R. 1448. See *United States* v. *Safety Car Heating & Lighting Co.*, 1936, 297 U.S. 88, 98, 56 S. Ct. 353, 80 L. Ed. 500. Plumb, "Income Tax on Gains and Losses in Litigation" (1940) 25 *Cornell L.Q.* 221. Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitations to be set forth below, is not taxable. *Farmers' & Merchants' Bank* v. *Commissioner*, *supra.* Plumb, *supra*, 25 *Cornell L.Q.* 221, 225. "Care must certainly be taken in such cases to avoid taxing recoveries for injuries to good will or loss of capital." 1 Paul and Mertens *Law of Federal Income Taxation* § 6.48.

Upon examination of Raytheon's declaration in its anti-trust suit we find nothing to indicate that the suit was for the recovery of lost profits. The allegations were that the illegal conduct of R.C.A. "completely destroyed the profitable interstate and foreign commerce of the plaintiff and thereby, by the early part of 1928, the said tube business of the plaintiff and the property good will of the plaintiff therein had been totally destroyed at a time when it then had a present value in excess of three million dollars and thereby the plaintiff was then injured in its business and property in a sum in excess of three million dollars." This was not the sort of antitrust suit where the plaintiff's business still exists and where the injury was merely for loss of profits. The allegations and evidence as to the amount of profits were necessary in order to establish the value of the good will and business since that is derived by a capitalization of profits A somewhat similar idea was expressed in *Farmers' & Merchants' Bank* v. *Commissioner*, *supra*, 59 F.2d at page 913. "Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery." Since the suit was to recover damages for the destruction of the business and good will, the recovery represents a return of capital. Nor does the fact that the suit ended in a compromise settlement change the nature of the recovery; "the determining factor is the nature of the basic claim from which the compromised amount was realized." Paul *Selected Studies in Federal Taxation*, Second Series, pp. 328–9, footnote 76; *Helvering* v. *Safe Deposit & Trust Co. of Baltimore*, 1941, 316 U.S. 56, 62 S. Ct. 925, 86 L. Ed. 1266, 139 A.L.R. 1513; *Lyeth* v. *Hoey*, 1938, 305 U.S. 188, 59 S. Ct. 155, 83 L. Ed. 119, 119 A.L.R. 410; *Central R. of New Jersey* v. *Commissioner, supra; Farmers'*

& Merchants' Bank v. *Commissioner, supra; Megargel* v. *Commissioner,* 1944, 3 T.C. 238.

But, to say that the recovery represents a return of capital in that it takes the place of the business good will is not to conclude that it may not contain a taxable benefit. Although the injured party may not be deriving a profit as a result of the damage suit itself, the conversion thereby of his property into cash is a realization of any gain made over the cost or other basis of the good will prior to the illegal interference. Thus A buys Blackacre for $5,000. It appreciates in value to $50,000. B tortiously destroys it by fire. A sues and recovers $50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages.

Compensation for the loss of Raytheon's good will in excess of its cost is gross income. See Magill *Taxable Income*, p. 339. 1 Mertens, *Law of Federal Income Taxation*, § 5.21, footnote 82. Plumb, *supra*, 25 *Cornell L.Q.* 225, 6.

Since we assume with the parties that the petitioner secured the original Raytheon's assets through a series of tax free reorganizations, petitioner's basis for the good will is the same as that of the original Raytheon. As the Tax Court pointed out, the record is devoid of evidence as to the amount of that basis and "in the absence of evidence of the basis of the business and good will of Raytheon, the amount of any nontaxable capital recovery cannot be ascertained." 1 T.C. 952. *Cf. Sterling* v. *Commissioner*, 2 Cir., 1937, 93 F.2d 304.

Where the cost basis that may be assigned to property has been wholly speculative, the gain has been held to be entirely conjectural and not taxable. In *Strother* v. *Commissioner*, 4 Cir., 1932, 55 F.2d 626, affirmed on other grounds, 1932, 287 U.S. 308, 53 S. Ct. 150, 77 L. Ed. 325, a trespasser had taken coal and then destroyed the entries so that the amount of coal taken could not be determined. Since there was no way of knowing whether the recovery was greater than the basis for the coal taken, the gain was purely conjectural and not taxed. Magill explains the result as follows: "as the amount of coal removed could not be determined until a final disposition of the property, the computation of gain or loss on the damages must await that disposition." *Taxable Income*, pp. 339–340. The same explanation may be applied to *Farmers' & Merchants' Bank* v. *Commissioner, supra*, which relied on the *Strother* case in finding no gain. The recovery in that case had been to compensate for the injury to good will and business reputation of the plaintiff bank inflicted by defendant reserve banks' wrongful conduct in collecting checks drawn on the plaintiff bank by employing "agents who would appear daily at the bank with checks and demand payment thereof in cash in such a manner as to attract unfavorable public comment." Since the plaintiff bank's business was not destroyed but only injured and since it continued in business, it would have been difficult to require the taxpayer to prove what part of the basis of its good will should be attributed to the recovery. In the case at bar, on the contrary, the entire business and good will were destroyed so that to require the taxpayer to prove the cost of the good will is no more impractical than if the business had been sold.[1]

. . . *The decision of the Tax Court is affirmed.*

[1] Since the plant and other physical assets of the taxpayer were not destroyed but were used by it in the new tube business under licenses from R.C A., the recovery was only for the destruction of business good will and not the physical assets.

Section F. Gifts, "Windfalls," and the Like

TAFT v. BOWERS.
GREENWAY v. SAME.

Supreme Court of the United States, 1929
278 U.S. 470

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

Petitioners, who are donees of stocks, seek to recover income taxes exacted because of advancement in the market value of those stocks while owned by the donors. The facts are not in dispute. Both causes must turn upon the effect of paragraph (2), § 202, Revenue Act 1921 (chapter 136, 42 Stat. 227, 229), which prescribes the basis for estimating taxable gain when one disposes of property which came to him by gift. The records do not differ essentially and a statement of the material circumstances disclosed by No. 16 will suffice.

During the calendar years 1921 and 1922 the father of petitioner, Elizabeth C. Taft, gave her certain shares of Nash Motors Company stock, then more valuable than when acquired by him. She sold them during 1923 for more than their market value when the gift was made.

The United States demanded an income tax reckoned upon the difference between cost to the donor and price received by the donee. She paid accordingly and sued to recover the portion imposed because of the advance in value while the donor owned the stock. The right to tax the increase in value after the gift is not denied.

Abstractly stated, this is the problem:

In 1916 *A* purchased 100 shares of stock for $1,000, which he held until 1923 when their fair market value had become $2,000 He then gave them to *B* who sold them during the year 1923 for $5,000. The United States claim that under the Revenue Act of 1921 *B* must pay income tax upon $4,000, as realized profits. *B* maintains that only $3,000—the appreciation during her ownership—can be regarded as income; that the increase during the donor's ownership is not income assessable against her within intendment of the Sixteenth Amendment.

The District Court ruled against the United States; the Circuit Court of Appeals held with them. . . .

We think the manifest purpose of Congress expressed in paragraph (2), § 202, *supra,* was to require the petitioner to pay the enacted tax.

The only question subject to serious controversy is whether Congress had power to authorize the exaction.

It is said that the gift became a capital asset of the donee to the extent of its value when received and, therefore, when disposed of by her no part of that value could be treated as taxable income in her hands.

The Sixteenth Amendment provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

Income is the thing which may be taxed—income from any source. The amendment does not attempt to define income or to designate how taxes may be laid thereon, or how they may be enforced.

Under former decisions here the settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.

Also, this court has declared:

"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets. *Eisner* v. *Macomber*, 252 U.S. 189, 207, 40 S. Ct 189, 193 (64 L. Ed. 521, 9 A L.R. 1570).

The "gain derived from capital," within the definition, is "not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit and disposal." *United States* v. *Phellis*, 257 U.S. 156, 169, 42 S. Ct. 63, 65 (66 L. Ed. 180).

If, instead of giving the stock to petitioner, the donor had sold it at market value, the excess over the capital he invested (cost) would have been income therefrom and subject to taxation under the Sixteenth Amendment. He would have been obliged to share the realized gain with the United States. He held the stock—the investment—subject to the right of the sovereign to take part of any increase in its value when separated through sale or conversion and reduced to his possession. Could he, contrary to the express will of Congress, by mere gift enable another to hold this stock free from such right, deprive the sovereign of the possibility of taxing the appreciation when actually severed, and convert the entire property into a capital asset of the donee, who invested nothing, as though the latter had purchased at the market price? And after a still further enhancement of the property, could the donee make a second gift with like effect, *etc.*? We think not.

In truth the stock represented only a single investment of capital—that made by the donor. And when through sale or conversion the increase was separated therefrom, it became income from that investment in the hands of the recipient subject to taxation according to the very words of the Sixteenth Amendment. By requiring the recipient of the entire increase to pay a part into the public treasury, Congress deprived her of no right and subjected her to no hardship. She accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor. When she sold the stock she actually got the original sum invested, plus the entire appreciation and out of the latter only was she called on to pay the tax demanded.

The provision of the statute under consideration seems entirely appropriate for enforcing a general scheme of lawful taxation. To accept the view urged in behalf of petitioner undoubtedly would defeat, to some extent, the purpose of Congress to take part of all gain derived from capital investments. To prevent that result and insure enforcement of its proper policy, Congress had power to require that for purposes of taxation the donee should accept the position of the

donor in respect of the thing received. And in so doing, it acted neither unreasonably nor arbitrarily.

The power of Congress to require a succeeding owner, in respect of taxation, to assume the place of his predecessor is pointed out by *United States* v. *Phellis,* 257 U.S. 156, 171, 42 S. Ct. 63, 66 (66 L. Ed. 180):

Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he was called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property. And *Irwin* v. *Gavit,* 268 U.S. 161, 167, 45 S. Ct. 475, 69 L. Ed. 897, is to the contrary.

The judgment below is affirmed.

The Chief Justice took no part in the consideration or decision of these causes.

Note

1. Examine § 1015(a) (the successor, in an amended form, of the provision involved in the foregoing case) with care. Using the illustration in the fifth paragraph of the opinion, what would *B*'s gain or loss be if he sold the stock for $750? For $1500? What if the stock had been bought by *A* for $2000, had been worth $1000 at the time of the gift, and had been sold by *B* for $5000? For $750? for $1500?

2. Could the donor have been constitutionally taxed at the time of the gift on the stock's increase in value during the period he held it? Section 1015(a) seems clearly, though not explicitly, to exempt the donor, at least in ordinary circumstances. The Internal Revenue Service in recent years has ruled to the contrary in a few special situations. See Griswold, "Charitable Gifts of Income and the Internal Revenue Code," 65 *Harv. L. Rev.* 84 (1951), Bittker, "Charitable Gifts of Income and the Internal Revenue Code· Another View," *id.* 1375 (1952), Griswold, "In Brief Reply," *id.* 1389, and Roehner and Roehner, "Realization· Administrative Convenience or Constitutional Requirement?" 8 *Tax L. Rev.* 173 (1953).

3. Dealers in securities *may* report their inventories of unsold securities at market, and thereby take "unrealized" gain or loss into account at the end of each year. Regs. 118, Sec. 39.22(c)-5. Could *all* taxpayers be *required* to account annually for unrealized gain and loss on their assets? Would such a scheme, if constitutional, be feasible?

4. Look at the first sentence of § 1014(a). If in the foregoing case the taxpayer's father had been elderly, what advice might have been given to him?

PARK & TILFORD DISTILLERS CORP. v. UNITED STATES.

U. S. Court of Claims, 1952
107 F. Supp. 941

Before JONES, Chief Judge, and LITTLETON, WHITAKER, MADDEN and HOWELL, Judges.

MADDEN, Judge.

The plaintiff has sued for the refund of corporation income and personal holding company income taxes paid by it for the year 1944. It paid the taxes, together with accrued interest, in 1949. The total payment was $285,257.24. The plaintiff filed a timely claim for refund, which has not been acted upon, and it is entitled to have its claim decided here on its merits.

The money which came to the plaintiff in 1944, and whose status as taxable income *vel non* is here in litigation, was paid to it by David A. Schulte. He was an officer and a director of the plaintiff corporation, and owned more than ten per cent of its stock. During the years 1942, 1943 and 1944 Schulte had sold and purchased, or purchased and sold, 9,900 shares of the plaintiff's stock in the open market, each purchase and sale or sale and purchase having occurred within a six-month period. He realized a profit of $264,827.57 on these transactions. Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C.A. § 78p(b) provides that when a person who owns more than ten per cent of the stock of a corporation makes a profit from selling and purchasing, or purchasing and selling, shares of the corporation's stock within a six-month period, he must turn his profits over to the corporation. The plaintiff corporation made a demand upon Schulte that he pay over to the corporation his profits of $264,827.57, and he did so in 1944. As we have said, it was this payment to the corporation which was taxed by the Government as income and which the plaintiff insists was not taxable income.

The money was paid to the plaintiff and became its money. In a general sense, then, it was income. But not everything of value that comes into one's control is taxable income. So far as is here pertinent, that is because the income tax statutes do not purport to levy an income tax on all money or things of value which come into one's control. We say, so far as is here pertinent, because we do not understand the plaintiff to suggest that Congress could not constitutionally tax the plaintiff on the money here in question. Our question, then, is a question of the proper construction of the income tax statutes.

Section 22(a) of the Internal Revenue Code, 26 U.S.C.A. § 22(a), says:

> (a) *General definition.* "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . , of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

The receipt of the money here in question seems not to fall within any of the language of Section 22(a) except the clause last quoted, "gains or profits and income derived from any source whatever." It was clearly not compensation for

services, or profits from sales, or rent, interest or dividends. But it was "income derived from any source whatever," unless those words, as used in the statute, have a meaning more restricted than their apparent meaning.

We see no reason for not giving the statutory language its natural meaning, as to the money here in question. It was, to be sure, a "windfall" to the plaintiff. If Congress were to select one kind of receipt of money which, above all others, would be a fair mark for taxation, it might well be "windfalls." That would not penalize industry nor discourage enterprise or economy as taxes on wages, salaries and profits do. At any rate we cannot imagine Congress expressly exempting windfalls from taxation as income, as it has done expressly with regard to gifts and inheritances. That being so, it is not for the courts, by the process of statutory construction, to create an exception which the legislature would quite certainly not have made if it had dealt expressly with the question.

The plaintiff relies upon language used by the Supreme Court of the United States in *Eisner* v. *Macomber*, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521. The question in that case was whether stock dividends distributed by a corporation to its shareholders, in proportion to their existing holdings, constituted taxable income. The court's decision was that they did not, they being merely evidence of accretions to capital which had not been "realized" by conversion into money in the hands of the shareholder. The shareholder still had the same interest in the corporation, though he now had two pieces of paper instead of one, to evidence that interest. The court said, 252 U.S. at page 207, 40 S. Ct. at page 193, with regard to the statutory language "gain derived from capital":

> . . . Here we have the essential matter: *not* a gain *accruing to* capital; not a *growth* or *increment* of value *in* the investment, but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *"derived"*—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property. Nothing else answers the description.

The court concluded that Congress could not constitutionally tax unrealized accretions to capital.

The instant case does not involve at all the problem of unrealized accretions to capital. The receipt of the money in question was, in every possible sense, a realization. The money came in from an outside source, it went into the plaintiff's treasury, it did not replace something which went out of plaintiff's ownership as a consideration for it. The decision in *Eisner* v. *Macomber*, *supra*, seems, then, not to be in point in the instant case. But in *Eisner* v. *Macomber* the court defined "income" for income tax purposes, as follows:

> ". . . the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets. . . .

We are unwilling to surmise that the court intended by this language, not necessary to its decision, to read out of the income tax statute language which Congress must have inserted with great deliberation and for important reasons, *viz.*, "income derived from any source whatever." It could not have so intended for constitutional reasons since the quoted language was taken almost literally from the Constitutional Amendment which authorized the taxation of incomes.

In *Helvering* v. *Clifford*, 309 U.S. 331, 334, 60 S. Ct. 554, 556, 84 L. Ed. 788, the court said:

The broad sweep of this language [Section 22(a)] indicates the purpose of Congress to use the full measure of its taxing power within those definable categories

In *Helvering* v. *Brunn*, 309 U.S. 461, 60 S. Ct. 631, 84 L. Ed. 864, the court said that its expressions in *Eisner* v. *Macomber* were merely for the purpose of clarifying the distinction between an ordinary dividend and a stock dividend, and were not controlling in the case then before it for decision. In *United States* v. *Safety Car Heating Co.*, 297 U.S. 88, 93, 56 S. Ct. 353, 356, 80 L. Ed. 500, the court said of the words "from any source whatever" as they appeared in the Revenue Act of 1926, § 213(a), 26 U.S.C.A. Int. Rev. Acts, page 163

We have said of that act that it reveals in its provisions an intention on the part of Congress to reach "pretty much every sort of income subject to the federal power." *Helvering* v. *Stockholms Enskilda Bank*, 293 U S 84, 89, 55 S. Ct. 50, 52, 79 L. Ed. 211

In *Douglas* v. *Willcuts*, 296 U.S. 1, 9, 56 S. Ct. 59, 62, 80 L. Ed. 3, the court said, of the definitions of gross income in the statutes

They are to be considered in the light of the evident intent of the Congress "to use its power to the full extent." *Irwin* v. *Gavit*, 268 U S. 161, 45 S. Ct 475, 476, 69 L. Ed. 897; *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84, 89, 55, S Ct. 50, 79 L. Ed. 211.

If we give heed to those repeated statements of the Supreme Court that Congress has intended, in the income tax laws, to use its power to the full extent, we must hold the payment here in question to be subject to the tax. It is not, and we think could not rationally be, suggested that Congress lacks the power to tax windfalls as income.

In *Rutkin* v. *United States*, 343 U.S. 130, 72 S. Ct. 571, the court held that an extortioner who coerced the payment of an nonexistent claim against another by threatening to inflict harm upon him and his family, was taxable upon the proceeds of his extortion. It is not possible to bring such income within the definition of income given by the court in *Eisner* v. *Macomber*, *supra.* Yet the court said, 343 U.S. at page 138, 72 S. Ct. at page 576:

We think the power of Congress to tax these receipts as income under the Sixteenth Amendment is unquestionable. The broad language of § 22(a) supports the declarations of this Court that Congress in enacting that section exercised its full power to tax income.

Congress has, of course, expressly exempted gifts from the income tax, and there are decisions holding transactions resembling gifts not taxable. In *Edwards* v. *Cuba Railroad*, 268 U.S. 628, 45 S. Ct 614, 69 L. Ed. 1124, it was held that a subsidy paid by a government to a railroad company for erecting a railroad was not taxable income to the railroad. The court said that the subsidy was a "windfall" and not subject to income tax. A windfall may, of course, be a gift, and thus expressly exempt from income tax. But if, as in the instant case, the windfall is clearly not a gift, but a payment required by a statute, see *Robertson* v. *United States*, 343 U.S. 711, 72 S. Ct. 994, we do not see how its exemption could be reconciled with the reiterated statements that Congress intended, by Section 22(a), to tax income to the extent of its constitutional power.

In addition to subsidies, the plaintiff cites other types of receipts by corporations which have been held not to constitute taxable income, viz., capital contributions, receipts from the sale of its own stock at a premium, forfeited stock subscriptions, and revaluation of appreciated assets. Most of the decisions cited

by the plaintiff in this connection are justifiable on the ground that the transaction involved a donation, or a purchase of an interest in the corporation, or an unrealized accession to the corporation's wealth. Such of them as must rest merely upon the definition of income in *Eisner* v. *Macomber*, which the Supreme Court no longer regards as authoritative except in cases involving stock dividends or analogous problems, we respectfully decline to follow, since we think they are not consistent with the tax statutes.

The plaintiff urges that the payment was a penalty imposed upon Schulte for the benefit of the plaintiff. That question would be of importance in a case where an inside trader, such as Schulte, sought to deduct the payment from his taxable income, either as a loss under Section 23(e) or as a business expense under Section 23(a)(1) of the Internal Revenue Code [§§ 162(a) and 165(c), 1954 Code]. The Tax Court of the United States has held that the insider is not entitled to the deduction, since to allow it would frustrate the policy of Section 16(b) *William F. Davis, Jr.*, 17 T.C. 549. In *Smolowe* v. *Delendo Corp.*, 2 Cir., 136 F.2d 231, 148 A.L.R. 300, and in *Dottenheim* v. *Emerson Electric Mfg. Co.*, E.D, N.Y., 7 F.R.D. 195 such payments have been called penalties. We do not understand, however, that the fact that *A*, who pays money to *B*, cannot deduct the amount of the payment from his income in computing his income tax, has any direct bearing upon whether the receipt of the payment by *B* is income to him. For example, if an employer pays wages or salaries in excess of those permitted by a wage stabilization law, and is therefore not entitled to charge them against his income as a business expense, that does not mean that they are not fully taxable to the employees who receive them.

The treatment, for income tax purposes, of a penalty, so far as the receiver of the penalty is concerned, is analogous to the treatment of damages received by him for some violation of his rights. Where damages are recovered in lieu of profits or income to which the taxpayer would have been entitled, but for the violation of his rights, they are taxable to him as income. *Swastika Oil & Gas Co.* v. *Commissioner*, 6 Cir., 123 F.2d 382, certiorari denied 317 U.S. 639, 63 S. Ct. 30, 87 L. Ed. 515; *Martin Bros. Box Co.* v. *Commissioner*, 6 Cir., 142 F.2d 457, affirming T.C. Memo. Decision.

It would seem that if the damages were awarded as a recompense for the impairment of a capital asset, they would not represent an economic gain and would not be taxable as income. Perhaps that is the *rationale* of *Farmers' & Merchants' Bank of Catlettsburg, Ky.* v. *Commissioner*, 6 Cir., 59 F.2d 912 where the taxpayer recovered damages from another person for conduct designed to destroy or injure the taxpayer's business. The damages recovered were held not to be taxable income. Cases such as *Central R. Co. of New Jersey* v. *Commissioner*, 3 Cir., 79 F.2d 697, 101 A.L.R. 1448, *Edward H. Clark*, 40 B.T.A. 333, and *Highland Farms Corporation*, 42 B.T.A. 1314, 1319, which seem to rest only upon the definition of income given by the Supreme Court in *Eisner* v. *Macomber*, do not seem to us persuasive.

The plaintiff's motion for summary judgment is denied and the petition is dismissed. It is so ordered.

JONES, Chief Judge, and HOWELL, WHITAKER and LITTLETON, Judges, concur.

Note

The Tax Court has come to the same conclusion, *General American Investors Co., Inc.* v. *Commissioner*, 19 T.C 581 (1952),* but in doing so, it distinguished and apparently reaffirmed its decisions in the *Clark* and *Highland Farms* cases, which the Court of Claims found "unpersuasive" The *Clark* case held non-taxable a payment to a taxpayer by his tax counsel to compensate him for loss suffered through erroneous advice in an earlier year. (Caveat to the student: the payment was $20,000.) The *Highland Farms* case involved actual and punitive damages imposed upon a creditor of the taxpayer for slandering its title and conspiring to wreck its business. See Note, The Taxability of Punitive Damages, 101 *U. of Pa. L. Rev.* 1052 (1953), Comment, Taxation of Found Property and Other Windfalls, 20 *U. of Chi. L. Rev.* 748 (1953).

COMMISSIONER v. GLENSHAW GLASS CO.
COMMISSIONER v. WILLIAM GOLDMAN THEATRES, INC.

U.S. Court of Appeals, Third Circuit, 1954
211 F.2d 928

Before BIGGS, Chief Judge, and MARIS, MCLAUGHLIN, KALODNER, STALEY and HASTIE, Circuit Judges.

BIGGS, Chief Judge.

The Commissioner seeks to reverse two decisions of the United States Tax Court in favor of two taxpayers. In Glenshaw a claim for punitive damages based upon a competitor's, Hartford's, fraudulent suits which disastrously affected the taxpayer's business, as well as a claim for treble damages under Section 4 of the Clayton Act, 15 U.S.C.A. § 15, were settled by the payment of a sum of money. In Goldman a judgment for treble damages was awarded Goldman against Loew's, Inc., also pursuant to Section 4 of the Clayton Act. The sole question presented for our determination is whether moneys paid as punitive or statutory treble damages are taxable as income under Section 22(a) of the Internal Revenue Code. The Tax Court has decided that they are not and the Commissioner of Internal Revenue has petitioned this court for review. Insofar as the issue before us is concerned no valid distinctions can be drawn between a money settlement and money paid in satisfaction of a judgment or between punitive damages levied for fraud and treble damages rendered under the Clayton Act.[1]

The positions of the taxpayers are based in large part upon the definition of

* This decision was affirmed by the Court of Appeals for the Second Circuit, 211 F 2d 522 (1954), which observed: "Is there some common principle or touchstone by the application of which one may infallibly determine what is and what is not in a given case 'gains or profits and income derived from any source whatever'? We think not The old definition of *Eisner* v. *Macomber* was perhaps contrived in the hope that a final and definitive solution had been found. But by reason of the very nature of the subject matter this was not to be. The decision in *Eisner* v. *Macomber* still stands, but the definition has met the common fate of generalities, and it has long since given way to an empirical case by case approach, which has the virtue of elasticity and makes possible a more sensible solution of new problems as they arise."

[1] The Commissioner and Glenshaw do not now dispute that $324,529.94 was the amount paid in settlement of punitive damages. In the Goldman case the amount of actual damage, found to be $125,000, was trebled and a judgment was entered for $375,000. We are concerned solely with the taxability of the sum of $324,529.94 (Glenshaw) and the taxability of $250,000 (Goldman).

"income" set out in *Eisner* v. *Macomber*, 1920, 252 U.S. 189, 207, 40 S. Ct. 189, 64 L. Ed. 521, on the decision of this court in *Central R. Co.* v. *Commissioner*, 3 Cir., 1935, 79 F.2d 697, 101 A.L.R. 1448, the decision of the Board of Tax Appeals in *Highland Farms Corporation* v. *Commissioner of Internal Revenue*, 1940, 42 B.T.A. 1314, and the applicable Treasury Regulations.[2] The taxpayers also assert considerations which are based on the general philosophy of income taxation but we will not discuss these specifically in this opinion But the United States for its part contends that *Eisner* v. *Macomber* does not settle the applicable definition of what constitutes taxable income insofar as the cases at bar are concerned, that the decision of this court in the *Central R. Co.* case is not applicable, but if it is, it was wrongly decided, and that the decision of the Board of Tax Appeals in *Highland Farms* was clearly erroneous. The substance of the government's argument is that all property or money coming into the hands of a taxpayer is income except where specifically exempted by the taxing statute.

In *Eisner* v. *Macomber* the Supreme Court stated [252 U.S. 189, 40 S. Ct. 193]: " 'Income may be defined as a gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. . . ." In *Eisner* v. *Macomber* the Supreme Court laid emphasis on the ordinary meaning of income in common parlance and said, 252 U.S. at pages 206–207, 40 S. Ct. at page 193 "For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the amendment. . . ." The second sentence of Treasury Regulations 118, § 39.22(a)-1, adopted the *Eisner* v. *Macomber* definition *in toto*. The only qualification of the second sentence of the regulation lies in the phrase "In general" and surely little can be taken from that. Of course, as the United States points out, in *Eisner* v. *Macomber* the Supreme Court was primarily concerned with distinguishing between capital and income, not between sources of property which came into the hands of the taxpayer and we cannot doubt but that the Supreme Court has departed in some degree from the *Eisner* v. *Macomber* definition. This is apparent from *United States* v. *Kirby Lumber Co.*,[3] 1931, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 where Mr. Justice Holmes stated: "We see nothing to be gained by the discussion of judicial definitions."

If the property or money paid represents a return of capital or a contribution of capital it is not subject to income taxation. Subsidies paid by a sovereign to aid in the construction and operation of a railroad line were held not to be in-

[2] The facts of the *Central R. Co.* case are distinguishable from those at bar. In the *Central R Co.* case the taxpayer received property in settlement of a suit brought by it against an unfaithful officer who violated his fiduciary duty to it and thereby deprived the railroad of revenues. A kind of resulting or constructive trust was imposed upon the fruits of his fraud in favor of the railroad company. Nevertheless this court considered the railroad's gain to be a "windfall," not derived either wholly or in part from the taxpayer's capital or labor and therefore not income at all within the definition of *Eisner* v. *Macomber*

The decision was followed by the Board of Tax Appeals in *Highland Farms Corporation*, *supra*, where punitive damages were allowed for slander of title to land. The Board of Tax Appeals refused to treat these punitive damages as income, relying also on the test of taxable income set out in Eisner v. Macomber.

[3] The lumber company purchased its own bonds in the open market at less than par and the difference in price was held to be taxable as income. It is clear, however, that compensatory damages for loss of income are taxable as income and that income takes its color from source See Chapter 10 "Compensatory Payments," *Taxable Income*, Magill, Rev. Ed , 1945, at p. 377 *et seq.*

come in *Edwards* v. *Cuba R. Co.*, 1925, 268 U S. 628, 45 S. Ct. 614, 69 L. Ed. 1124, and the money and property acquired were treated in effect as an accretion to capital. But compare *Detroit Edison Co.* v. *Commissioner*, 1943, 319 U.S. 98, 63 S. Ct. 902, 87 L. Ed. 1286, where the Supreme Court has indicated some halt in the doctrine of capital donation expressed in *Edwards* v. *Cuba R. Co., supra. Cf.* also *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225 (1927), affirmed 8 Cir., 1930, 40 F.2d 372. A single gift of money or property probably should not be treated as taxable income even if the specific exemption granted to gifts by statute were unavailable. Periodicity seems to be considered a factor. See *Irwin* v. *Gavit*, 1925, 268 U.S. 161, 168, 45 S. Ct. 475, 69 L. Ed. 897; Magill, *Taxable Income, supra*, note 3, at p. 428. The spontaneity of the gift may also serve to relieve the recipient of tax. See *Bogardus* v. *Commissioner*, 1937, 302 U.S. 34, 42, 58 S. Ct. 61, 82 L. Ed. 32; *Washburn* v. *Commissioner*, 1945, 5 T.C. 1333.

The United States lays emphasis on the decision of the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, Ct. Cls. 1952, 107 F. Supp. 941, 943–945. In this case the issue was whether a recovery under Section 16(b) of the Securities Exchange Act, 15 U.S.C.A. § 78p(b), constituted income to the recovering corporate taxpayer. The Court of Claims held that the recovery was taxable as income and specifically rejected the reasoning of this court in *Central R. Co.* v. *Commissioner* and the decision of the Board of Tax Appeals in *Highland Farms*. The Court of Claims stated: "The money came in from an outside source, it went into the plaintiff's treasury, it did not replace something which went out of plaintiff's ownership as a consideration for it." The Court went on to say that it was unwilling to surmise that the definition of "income" of *Eisner* v. *Macomber* was sufficient to read out of the taxing statute the phrase "income derived from any source whatever." In our opinion the theory of recovery under Section 16(b) of the Securities Exchange Act of 1934 is not a purely punitive one. The statute was designed to prohibit profit being made by an "insider" possessing peculiar knowledge of future profitable operations of his corporation. The making of a profit by the "insider" is the mainspring of the statute, a profit required by law to be passed on to the corporation probably because the corporation is the most convenient receptacle. An "outsider" purchasing stock in the open market, theoretically at least, would be compelled to pay a higher price because an insider was purchasing stock in the market against him. But, under the operation of the statute, all of the stockholders, save only the "insider" whose operations were prohibited by statute, would receive via the corporate entity the profit made by the prohibited transaction. We do not agree with the position of the Court of Claims that Park & Tilford's recovery was purely a "windfall."

In *General American Investors Co., Inc.* v. *Commissioner*, 1952, 19 T.C. 581, affirmed 2 Cir, 1954, 211 F.2d 522, the Tax Court followed the *Park & Tilford* decision of the Court of Claims but distinguished its decision from that in the instant *Glenshaw Glass Company* case and the decisions in *Central R. Co.* and *Highland Farms* employing the definition of taxable income of *Eisner* v. *Macomber*. Judge Murdock in his concurring opinion pointed to the provisions of Section 16(b) of the Securities Exchange Act of 1934, *viz.*, that "any profit realized" under the circumstances presented by the *General American Investors* case "shall

inure to and be recoverable by the issuer," i.e., the corporation. Judge Murdock took the position that the profits were income to General American Investors within the purview of Section 22(a) of the Internal Revenue Code "since they were 'profits' either from 'sales or dealings in property . . . growing out of the ownership of . . . or interest in such property' or 'from any source whatsoever'."

The facts of the *Park and Tilford* and the *General American Investors* decisions are distinguishable both from those at bar and from *Central R. Co.* v. *Commissioner, supra.*

The United States contends that the "source of gain" should not be controlling in view of the final phrase of Section 22(a) dealing with gains or profits or income "derived from any source whatever"; that the phrase last quoted expresses congressional intent that the source of income or gain is immaterial—a complete negation of the concept of source in relation to taxable income. The government in substance asserts that any money or property coming into the hands of any person is taxable as income unless specifically exempted. But we have found no case in which the court did not look to source as at least coloring or bearing upon the incidence of taxation.

Punitive damages seem to be *sui generis.* By definition they are not compensatory. They certainly possess no periodicity. They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets. It is clear that they do not fall within the definition of *Eisner* v. *Macomber* and if we could be certain that the definition of that case was controlling we would have no difficulty with the issue at bar. It is easy to say what punitive damages are not but difficult to say what they really are. They smack of donations made to the individual by the State, by operation of law. A person does a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo.* An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. *Cf Edwards* v. *Cuba R. Co., supra.* Where the injuries were gross, the doctrine of punitive damages comes into play. The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer.

The Supreme Court has never expressly departed from the definition of income of *Eisner* v. *Macomber.* In fact it has reiterated it fairly recently. See *Merchants Loan & Trust Co.* v. *Smietanka,* 1921, 255 U.S. 509, 519, 41 S. Ct. 386, 65 L. Ed. 751 and *Commissioner of Internal Revenue* v. *Culbertson,* 1949, 337 U.S. 733, 740, 69 S. Ct. 1210, 93 L. Ed. 1659. And see *Helvering* v. *Griffiths,* 1943, 318 U.S. 371, 63 S. Ct. 636, 87 L. Ed. 843 in which the Supreme Court expressly declined to overrule *Eisner* v. *Macomber* on the facts there presented. The *Culbertson* decision cites not only Treasury Regulation 118, Article 39.22(a)–1 but also 1 Mertens, *Law of Federal Income Taxation,* 159 *et seq.* See the authorities set out in note 9 cited to § 5.02 of Mertens. We concede that no definition is too helpful, *United States* v. *Kirby Lumber Co., supra,* and

that the decisions relating to income tax law contain charts rather than definitions, as Mr. Mertens has aptly stated. But it should be borne in mind that in *Eisner* v. *Macomber*, albeit where severability was the primary issue, the Supreme Court said, 252 U.S. at pages 206–207, 40 S. Ct. at page 193, that "only a clear definition of the term 'income,' as used in common 'speech' . . . ." was required. We do believe that a "windfall"—and the payments at bar were "windfalls"—would not be regarded as "income" within the terms of common speech. Certainly the payments to the taxpayers cannot fairly be regarded as products of capital or labor. We believe that the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him. This is perhaps an over-simplification but we are of the opinion that the ordinary man using terms of common speech would not regard punitive damages as "income."

We must further concede that the decision of this court in *Central R. Co.* v. *Commissioner* cannot be deemed to be overwhelmingly persuasive for the sources of the moneys in that case can be distinguished from the sources of the moneys sought to be taxed in the instant cases but the decision has been followed frequently and has been applied to the issue of taxation of punitive damages. See *Highland Farms, supra.* There is as yet no decision which has adopted the contentions made by the Government here. The position of the United States would indeed, if adopted, bring symmetry into this aspect of the law of income taxation. See "The Taxability of Punitive Damages," 101 *U. of P. L. Rev.* 1052 (1953). *Cf. Keasbey & Mattison Co.* v. *Rothensies*, 3 Cir., 1943, 133 F.2d 894, 897. But we think if such a result is to be achieved after nearly two decades it should be effected by the Supreme Court and not by this tribunal.

The decisions of the Tax Court will be affirmed.

Section G. Control and Claim of Right

UNITED STATES v. LEWIS

Supreme Court of the United States, 1951
340 U.S. 590

Mr. Justice Black delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment he returned approximately $11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV–1 Cum. Bull. 179 (1936). The Court of Claims, however, relying on its own case, *Greenwald* v. *United States*, 57 F. Supp. 569, 102 Ct. Cl. 272, held that the excess bonus received "under a mistake of fact" was not income in 1944 and ordered a refund based on a recalculation of that year's tax. 91 F. Supp. 1017, 1022. We granted certiorari, 340 U.S. 903, 71 S. Ct. 279, because this holding conflicted with many decisions of the courts of appeal, see, *e.g.*, *Haberkorn* v. *United States*, 6 Cir., 173 F. 2d 587, and with principles announced in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 52 S. Ct. 613, 76 L. Ed. 1197.

In the North American Oil case we said:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [*i e.*, to report], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. 286 U.S. at 424, 52 S. Ct. at page 615, 76 L. Ed. 1197.

Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by *Freuler* v. *Helvering*, 291 U.S. 35, 54 S. Ct. 308, 78 L. Ed. 634, or *Com'r* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546, 90 L. Ed. 752. The *Freuler* case involved an entirely different section of the Internal Revenue Code, and its holding is inapplicable here. 291 U.S. at 43, 54 S. Ct. at page 311, 78 L. Ed. 634. And in *Com'r* v. *Wilcox*, *supra*, we held that receipts from embezzlement did not constitute income, distinguishing *North American Oil* on the ground that an embezzler asserts no "bona fide legal or equitable claim." 327 U.S. at 408, 66 S. Ct. at page 549, 90 L. Ed. 752.

Income taxes must be paid on income earned (or accrued) during an annual accounting period. *Cf.* I.R.C. §§ 41, 42, 26 U.S.C.A. §§ 41, 42; and see *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363, 51 S. Ct. 150, 151, 75 L. Ed. 383. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, *Law of Federal Income Taxation*, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.[1]

Reversed.

MR. JUSTICE DOUGLAS (*dissenting*).

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later however it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the

[1] It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. I.R.C. § 322(b), 26 U.S.C.A. § 322(b) [§ 6511(a), 1954 Code].

law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.

Note

The question in the foregoing case is entangled with accounting concepts, and its ramifications will be considered later. Chapter 8, Sec. C(2). But the student should bear in mind that a system of annual accounting for income will inevitably breed disputes over the proper year to report numerous items and may require some to be reported in one year though they are repaid in another.

Section 1341 of the 1954 Code allows the taxpayer to get a refund for the earlier year, instead of taking a deduction in the later year, in the case of many refunds, if the amount exceeds $3000

RUTKIN v. UNITED STATES

Supreme Court of the United States, 1952

343 U.S. 130*

MR. JUSTICE BURTON delivered the opinion of the Court.

The principal issue before us is whether money obtained by extortion is income taxable to the extortioner under § 22(a) of the Internal Revenue Code. For the reasons hereafter stated we hold that it is.

The petitioner, Rutkin, was indicted under I.R.C. § 145(b)[1] [see § 7201, '54 Code], for willfully attempting to evade and defeat a large part of his income and victory taxes for 1943. He was charged with filing a false and fraudulent return stating his net income to be $18,966.64, whereas he knew that it was $268,622.04. That difference, which would increase his tax liability from $6,843.93 to $222,408.32, was due largely to his omission from his original return of $250,000 received by him in cash from Joseph Reinfeld. The United States claims that this sum was obtained by petitioner by extortion and as such was taxable income. Petitioner contests both the fact that the money was obtained by extortion and the conclusion of law that it was taxable income if so obtained. He contends also that he did not willfully attempt to evade or defeat the tax. Petitioner was found guilty by a jury in the United States District Court for the Disrict of New Jersey, fined $10,000 and sentenced to four years in prison. The Court of Appeals affirmed, one judge dissenting. 189 F.2d 431. We granted certiorari, 342 U.S. 808, 72 S. Ct. 50, so as to pass upon the alleged conflict between that decision and the decision in *Commissioner of Internal Revenue* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546, 90 L. Ed. 752.

* A petition for retrial, based on claims of newly discovered evidence and fraud by the government's principal witness, was denied by the District Court and its action was affirmed, one judge dissenting, by the Court of Appeals. United States v. Rutkin, 208 F.2d 647 (3d Cir. 1954). [Ed.]

1 "§ 145. Penalties . . .

"(b) . . . attempt to defeat or evade tax. . . . any person who willfully attempts in any manner to evade or defeat any tax imposed by this chapter or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution." 53 Stat. 62–63, 26 U.S.C. § 145(b), 26 U.S.C.A. § 145(b).

The facts are unusual but there can be no doubt that, under the instructions given the jury, we must regard its verdict as reflecting its conclusion that the $250,000 was obtained by petitioner by extortion. There was substantial evidence supporting that result. Reinfeld's first association with petitioner was in 1929 with several others in a bootlegging operation known as the "High seas venture." It was accomplished through the use of a ship in the sale of whiskey at sea more than 12 miles from shore. Reinfeld testified that petitioner contributed no money to the enterprise but was taken in because Reinfeld's associates were afraid that otherwise they would get "interference and trouble" from petitioner. His interest was recognized to be 6% but, when the venture was liquidated in 1933, he already was overdrawn and no distribution was made to him. Without including petitioner, the others then organized Browne Vintners Co., Inc., a New York corporation, to engage in the liquor business. In 1936 petitioner, without making an investment, claimed a 6% interest in Browne Vintners. Despite Reinfeld's denial of petitioner's claim, Reinfeld paid him $60,000 and took from him an assignment of "any and all of such shares of capital stock in the said Browne Vintners Co. Inc., that I am entitled to." In 1940 all the Browne Vintners stock was sold for $7,500,000 to a purchaser who also assumed $8,000,000 of the company's debts. The shares of stock when sold stood in the names of, and were transferred by, "nominees" so as to conceal the identity of Reinfeld and the other beneficial owners. A capital gains tax upon the profits from these sales was paid by the respective nominees.[2] Petitioner was neither a stockholder of record nor a beneficial owner of any of the stock of the company at any time.

In 1941, in response to petitioner's request, Reinfeld gave him about $10,000 to help buy a tavern. When petitioner used the money for other purposes Reinfeld refused to finance him further and his "trouble" with petitioner began. In 1942 petitioner again claimed that he had had an interest in Browne Vintners Company and that Reinfeld must give him $100,000 to help him pay his debts. Upon Reinfeld's refusal, petitioner threatened to kill him. From that time on, the record presents a lurid story of petitioner's unsatisfied demands upon Reinfeld for various sums up to $500,000, petitioner's threatening use of a gun and his repeated statements that he would kill Reinfeld and Reinfeld's family unless his demands were met. Finally, on May 11, 1943, in New Jersey, Reinfeld paid petitioner $250,000 in cash.

Throughout this melodrama petitioner asserted that he was entitled to the payments he demanded from Reinfeld because of petitioner's alleged former interest in Browne Vintners Company. That interest never was identified by petitioner. Reinfeld and others testified positively that petitioner never had any such interest. Nevertheless, on May 11, Reinfeld handed to petitioner $250,000 in cash at the same time that Reinfeld paid $358,000 to Zwillman and Stacher representing their conceded interest in the proceeds of Browne Vintners stock. Petitioner, with Zwillman and Stacher, thereupon signed a "general release." It did not state

[2] The United States concedes that although, on a strict construction of the Internal Revenue Code, it may be that the proceeds of the sales should have been reported by the beneficial rather than by the record owners, their failure to so report the proceeds does not provide a satisfactory basis for a charge against them of a willful attempt to evade and defeat the tax in violation of § 145(b).

the amounts paid but it did purport to release Reinfeld, Browne Vintners Company and others from all claims the signers had against them.

Under the jury's verdict, we accept the fact to be that petitioner had no basis for his claim to this $250,000 and that he obtained it by extortion. Accordingly, if proceeds of extortion constitute income taxable to the extortioner, his omission of it from his tax return was unlawful. The further factual issue whether, under all the surrounding circumstances, petitioner's omission of the $250,000 from his tax return amounted to a willful attempt to evade and defeat the tax is not open to review here. That issue is settled by the verdict of the jury supported by substantial evidence. It remains for us to determine the legal issue of whether money obtained by extortion is taxable to the extortioner under § 22(a).

Under the instructions to the jury, extortion here meant that the $250,000 was paid to petitioner in response to his false claim thereto, his harassing demands therefor and his repeated threats to kill Reinfeld and Reinfeld's family unless the payment were made. Petitioner was unable to induce Reinfeld to believe petitioner's false and fraudulent claims to the money to be true. He induced Reinfeld to consent to pay the money by creating a fear in Reinfeld that harm otherwise would come to him and to his family. Reinfeld thereupon delivered his own money to petitioner. Petitioner's control over the cash so received was such that, in the absence of Reinfeld's unlikely repudiation of the transaction and demand for the money's return, petitioner could enjoy its use as fully as though his title to it were unassailable.

An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. *Burnet* v. *Wells*, 289 U.S. 670, 678, 53 S. Ct. 761, 764, 77 L. Ed. 1439; *Corliss* v. *Bowers*, 281 U.S. 376, 378, 50 S. Ct. 336, 337, 74 L. Ed. 916. That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.

Such gains are taxable in the yearly period during which they are realized. This statutory policy is invoked in the interest of orderly administration. "[C]ollection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant." *National City Bank* v. *Helvering*, 2 Cir., 98 F.2d 93, 96. There is no adequate reason why assailable unlawful gains should be treated differently in this respect from assailable lawful gains. Certainly there is no reason for treating them more leniently. *United States* v. *Sullivan*, 274 U.S. 259, 263, 47 S. Ct. 607, 71 L. Ed. 1037.

There has been a widespread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds under § 22(a). The application of this section to unlawful gains is obvious from its legislative history. Section II, subd. B of the Income Tax Act of 1913 provided that "the net income of a taxable person shall include gains, profits, and income . . . from . . . the transaction of any *lawful* business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ." (Emphasis supplied.) 38 Stat. 167. In 1916, 39 Stat. 756, this was amended by omitting the one word "lawful" with the obvious intent thereafter to tax unlawful as well as lawful gains, profits or income derived from any source whatever.

There is little doubt now that where unlawful gains are secured by the fraud of the taxpayer they are taxable. In the instant case it is not questioned that the $250,000 would have been taxable to petitioner if he had obtained it by fraudulently inducing Reinfeld to believe petitioner's false claims to be true. That being so, it would be an extraordinary result to hold here that petitioner is to be tax free because his fraud was so transparent that it did not mislead his victim and his victim paid him the money because of fear instead of fraud.

We do not reach in this case the factual situation involved in *Commissioner of Internal Revenue* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546, 90 L. Ed. 752. We limit that case to its facts. There embezzled funds were held not to constitute taxable income to the embezzler under § 22(a). The issue here is whether money extorted from a victim with his consent induced solely by harassing demands and threats of violence is included in the definition of gross income under § 22(a). We think the power of Congress to tax these receipts as income under the Sixteenth Amendment is unquestionable. The broad language of § 22(a) supports the declarations of this Court that Congress in enacting that section exercised its full power to tax income. We therefore conclude that § 22(a) reaches these receipts.

We have considered the other contentions of petitioner but find them without merit sufficient to justify a reversal or remand of the case.

The judgment of the Court of Appeals accordingly is affirmed.

Affirmed.

MR. JUSTICE BLACK, with whom MR. JUSTICE REED, MR. JUSTICE FRANKFURTER, and MR. JUSTICE DOUGLAS concur, *dissenting.*

In *Commissioner of Internal Revenue* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546, 90 L. Ed. 752, decided February, 1946, we held that embezzled money did not constitute taxable income to the embezzler under § 22(a) of the Internal Revenue Code. We there pointed out that the embezzler had no bona fide legal or equitable claim to the money, was under a definite legal obligation to return it to its rightful owner, and consequently had no more received the kind of "gain" or "income" which Congress has taxed than if he had merely borrowed money. One who extorts money not owed him stands in this precise situation. He has neither legal nor equitable claim to the extorted money and is under a continuing obligation to return it to its owner. See, *e.g., Bank of the United States* v. *Bank of Washington*, 6 Pet. 8, 19, 8 L. Ed. 299, *Miller* v. *Eisele*, 111 N.J.L. 268, 168 A. 426; 2 N.J.S.A. 2:73-1. A comparison of MR. JUSTICE BURTON's opinion in this case with his dissent in the *Wilcox* case reveals beyond doubt that the Court today adopts the reasoning of his prior dissent, thereby rejecting the *Wilcox* interpretation of § 22(a). A tax interpretation which Congress has left in effect for six years is thus altered largely as a consequence of a change in the Court's personnel. I think that our former interpretation was right and do not believe that the Government is suffering because of a failure to collect income taxes from embezzlers and extortioners. Indeed further considerations strengthen my support of our *Wilcox* holding.

I fully agree that earnings from businesses such as gambling and bootlegging are subject to the income tax law even though these earnings are derived from illegal transactions. *United States* v. *Sullivan*, 274 U.S. 259, 47 S. Ct. 607, 71

L. Ed. 1037. The majority seems to think that the *Wilcox* case holds otherwise because some states have laws which under special circumstances permit some particular groups to assert a legal claim for recovery of gambling losses or money paid for bootleg liquor. But these state laws vary far too much in their scope and operation to justify saying that these businessmen never have a bona fide legal or equitable claim to monies paid them. And ". . . we must generally assume, in the absence of a plain indication to the contrary, that Congress when it enacts a statute is not making the application of the federal act dependent on state law." *Jerome* v. *United States*, 318 U.S. 101, 104, 63 S. Ct. 483, 485, 87 L. Ed. 640. Moreover, even if we were to take these state recoupment laws into consideration, the sums recovered under them would do no more than decrease the yearly net earnings of such questionable businesses. To all intents and purposes bootleggers and gamblers are engaged in going businesses and make regular business profit which should be taxed in the same manner as profits made through more legitimate endeavor However, in my judgment it stretches previous tax interpretations too far to classify the sporadic loot of an embezzler, an extortioner or a robber as taxable earnings derived from a business, trade or a profession. I just do not think Congress intended to treat the plunder of such criminals as *theirs*.

It seems illusory to believe, as the majority apparently does, that the burden on honest American taxpayers will be lightened by a governmental policy of pursuing extortioners in futile efforts to collect income taxes. I venture the guess that this one trial has cost United States taxpayers more money than the Government will collect in taxes from extortioners in the next twenty-five years. If this statute is to be interpreted on the basis of what is financially best for honest taxpayers, it probably should be construed so as to save money by eliminating federal prosecutions of state crimes under the guise of punishing tax evaders.

Since it seems pretty clear that the Government can never collect substantial amounts of money from extortioners, there must be another reason for applying the tax law to money they extract from others. The Government's brief is suggestive of the only other reason that occurs to me—to give Washington more and more power to punish purely local crimes such as embezzlement and extortion. Today's decision illustrates an expansion of federal criminal jurisdiction into fields of law enforcement heretofore wholly left to states and local communities. I doubt if this expansion is wise from the standpoint of the United States or the states.

Insofar as the United States is concerned, many think that taking over enforcement of local criminal laws lowers the prestige of the federal system of justice. It certainly tends to make the federal system top-heavy. Of supreme importance is the fact that the United States cannot perform the monumental tasks which lie beyond state power if the time, energy and funds of federal institutions are expended in the field of state criminal law enforcement.

Federal encroachment upon local criminal jurisdiction can also be very injurious to the states. Extortion, robbery, embezzlement and offenses of that nature are traditionally matters of local concern. The precise elements of these offenses as well as the problems underlying them vary from state to state. Federal assumption of the job of enforcing these laws must of necessity tend to free the states from a sense of responsibility for their own local conditions. Even when states

attempt to play their traditional role in the field of law enforcement, the overriding federal authority forces them to surrender control over the manner and policy of construing and applying their own laws. State courts not only lose control over the interpretation of their own laws, but also are deprived of the chance to use the discretion vested in them by state legislatures to impose sentences in accordance with local ideas. Moreover, state prosecutors are deprived of the all-important function of deciding what local offenders should be prosecuted. Final authority to make these important decisions becomes located in the distant city of Washington, D. C. Here, as elsewhere, too many cooks may spoil the broth.

Moreover, I doubt if this expansion of federal criminal jurisdiction can be carried on in a manner consistent with our traditional ideas of what constitutes a fair trial in criminal cases. There is the question of the wisdom and fairness of subjecting a person to double and even triple prosecutions for the same conduct, since the nation, state and municipality might make this one mistake or wrong punishable as a crime.

That consideration gives additional weight to the view that where Congress is creating offenses which duplicate or build upon state law, courts should be reluctant to expand the defined offenses beyond the clear requirements of the terms of the statute. *Jerome* v. *United States*, supra, 318 U.S. at page 105, 63 S. Ct. at page 486.

Of course, looked at technically, multiple prosecutions for the same conduct could be avoided by national prosecution of one part of the conduct, state prosecution of another part, and municipal prosecution of a third part. This would still leave a defendant faced with the burden of defending three separate prosecutions.

Expansion of federal criminal jurisdiction entails many other unfair and complicating factors. Criminal rules of substance and of procedure vary widely among the jurisdictions. Punishment is frequently different. In fact, the same kind of conduct may be ignored as not worth criminal punishment by one jurisdiction while considered a serious criminal offense by another. For example, under the Federal White Slave Law men can be imprisoned five years for conduct which many states would not hold criminal at all. Schwartz, "Federal Criminal Jurisdiction and Prosecutors' Discretion," 13 *Law and Contemporary Problems* 64, 72. When faced with specific federal legislation, such differences in treatment may be inevitable, but I do not think the tax laws should be judicially extended for the purpose of taking from local officials the responsibility for prosecuting local offenses.

When the Government takes over a case like the one before us, the resulting confusion of issues is manifestly prejudicial to the defendant. Here for instance it can hardly be said that Rutkin was tried for tax evasion. Most of the 900 printed pages of oral testimony in the two week's trial are devoted to proof of things other than an attempt to evade the tax. Four pages deal with Rutkin's allegedly false 1943 tax return; three pages deal with the amount of tax Rutkin would have owed if he had received $250,000 more income than he actually reported; six pages contain testimony of Rutkin tending to show willful evasion of the tax laws so as to bring the case within *Spies* v. *United States*, 317 U.S. 492, 63 S. Ct. 364, 87 L. Ed. 418. A mere reference to the contents of the remaining 887

pages shows what a great threat there was that Rutkin would be convicted because he was a "bad man" ("scoundrel" to use the trial court's title) regardless of whether he was guilty or innocent of the tax evasion charged.

Most of the evidence dealt with the following aspects of Rutkin's past life and associations: Back in prohibition days Rutkin had joined one Reinfeld and others in a bootlegging scheme called the "High seas venture." The organization made millions. About 1940, some time after prohibition ended, Reinfeld, apparently acting for the group, sold the business establishment for about $7,500,000 net. Reinfeld's accounting methods and management of the proceeds were not satisfactory to his associates. They claimed that Reinfeld held back more than his share of the millions. Reinfeld claimed that some of his former associates, including Rutkin, were "overdrawn" and entitled to nothing out of the $7,500,000. This quarrel went on for several years during which time Reinfeld was required to pay hundreds of thousands of dollars to former partners as a result of their claims that he had swindled them. Rutkin was one of them. Rutkin's $250,000 was paid to him by lawyers whose reputations seem to have been above reproach. It was paid openly. And it was some eight years later when Rutkin sued Reinfeld for more millions that Reinfeld, apparently for the first time, charged that Rutkin had extorted the $250,000 under threats of death. Yet he has been convicted here of federal tax evasion on the theory that he was guilty of the crime of "extortion."

From the beginning to the end the evidence in this case was devoted to showing the lawless life Rutkin, Reinfeld and their associates led from the 1920's to 1950, ranging from bootlegging to bribery to gambling. The charge of the court largely emphasized and reemphasized the iniquity of the criminal conduct shown by the testimony. Early in his charge the trial court told the jury:

> You are not deciding which is the bigger scoundrel, Reinfeld or Rutkin, they have both blandly admitted on the stand that they prostituted justice in this country; that they paid public servants to close their eyes to law violation, and that is a canker which eats away at the body public. But you are not passing upon respective degrees of scoundrelism between any two people. The bland way in which we were told that the Reinfelds and the Rutkins and the Zwillmans and all of the others prostituted justice should give us cause for pause, but we are not passing on that question now.

In concluding his charge the trial court told the jury:

> The Government of the United States doesn't ask you to sacrifice anybody to prove its might. It asks you to do justice. That's all that Rutkin has a right to ask you to do, and that's what the government of the United States asks you to do. It asks you to remember its rights too, remembering that unpunished crime, undetected crime, are threats to the majesty and dignity of our government; and that unpunished crime undermines our government. We all of us must do that which is our duty and do it without fear or favor.

My study of this record leads me to believe that the fantastic story of supposed extortion told here would probably never have been accepted by a jury if presented in a trial uncolored by the manifold other inflammatory matters which took up 887 of the 900 pages in this "tax evasion" case.

If we are going to depart from the *Wilcox* holding, I think this is a poor case in which to do so. I would reverse this judgment.

Note

1. Do the dissenters believe that it is unconstitutional to tax extorters, or only that Congress did not intend to tax them? In their view would Rutkin have realized income once the statute of limitations barred a recovery of the funds by his victim? See last sentence of G.C.M. 24945, 1946-2 C.B. 27.

2. Would the government's tax claim against Rutkin be superior to the claim of the victim if there was not enough to pay both? See generally Note, 62 *Yale L.J.* 662 (1953).

3. In the Wilcox case, 327 U.S. 404 (1946), which the Court now holds must be limited "to its facts," the Court said:

> . . . taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of Section 22(a).

On several subsequent occasions persons prosecuted for tax evasion have denied they were business men, endeavoring instead to masquerade as embezzlers *Ho* v. *United States*, 186 F.2d 574 (9th Cir. 1951), *Currier* v *United States*, 166 F 2d 346 (1st Cir. 1948) An especially ingenious (but unsuccessful) attempt to exploit the *Wilcox* case is to be found in *Kann* v. *Commissioner*, 18 T C. 1032 (1952). Officers and stockholders of a corporation had caused it to understate its income, pocketing the amounts in question and omitting them also from their individual return. When the Commissioner assessed deficiencies against them individually, they took the position that the funds were not taxable because embezzled from the corporation. The minutes of the board of directors (several years after the events in question) stated that the officers had "explained the amounts and circumstances involving the unauthorized withdrawal . . . for their own use of certain funds belonging to the Company" and that they admitted owing these funds and intended to repay them to the corporation. The Tax Court said:

> Petitioners were never indicted nor convicted of embezzlement, and there is hence no external evidence as there was in *Wilcox* that they were guilty of that offense. They were in complete control of the corporations from which they obtained the funds and there is in fact no adequate proof that the method if not the act has not been forgiven or condoned. The details of the supposed liability to repay are such as to leave serious doubt whether the whole project was not a false front erected to deceive not the corporation nor its stockholdcis but the Commissioner of Internal Revenue.

In a final twist of the screw, the Court said that since the petitioners were self-confessed defrauders, their testimony that they had embezzled was entitled to little weight. The Tax Court was affirmed by a divided Court of Appeals. *Kann* v. *Commissioner*, 210 F.2d 247 (3rd Cir. 1954); see also *Ace Tool & Eng., Inc.* v. *Commissioner*, 22 T.C No. 101 (1954).

4. The *Wilcox* case had been subject to some airy distinctions even before the *Rutkin* case was decided. In *United States* v. *Iozia*, 104 F. Supp. 846 (S.D N.Y. 1952), it was held that an embezzler of property realizes income on selling the property; in *Akers* v. *Scofield*, 73 F. Supp. 553 (W.D. Tex. 1947), it was held that a swindler realizes income because, unlike an embezzler, he acquires title to the money, at least until it is "divested out of him by court action." See also *Rollinger* v. *United States*, 208 F.2d 109 (8th Cir. 1953), involving funds obtained by selling zircons as diamonds and by later "shaking down" the buyer by persuading him that the gems had been stolen and that bribes were necessary to prevent detection.

5. Although it was held as long ago as 1927 that illegal income is taxable, *United States* v. *Sullivan*, 274 U.S. 259 (1927), involving the income of a bootlegger during Prohibition, the extent to which recipients of such income must keep records and report the details on their tax returns is still uncertain. Perhaps the United States may

compel recording and reporting the details of income connected with violations of *state* law, but federal compulsion to reveal violations of *federal* law is another matter. The taxpayer could not be compelled to give testimony that would incriminate himself, can he be required to keep books and records or to execute a tax return that will do so? In the *Sullivan* case, Mr. Justice Holmes, writing for a unanimous court, said only:

> If the form of return provided called for answers that the defendant was privileged from making he could have raised the objection in the return, but could not on that account refuse to make any return at all. We are not called on to decide what, if anything, he might have withheld. Most of the items warranted no complaint. It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime.

Investigations in recent years by the Kefauver Committee and others have revealed that when illegal income is reported, it is often designated merely as "commissions," "fees," "other income," and the like, rather than labelled specifically Must the government tolerate this kind of reporting? In *Shapiro* v. *United States*, 335 U.S. 1 (1948), it was held that the privilege against self-incrimination does not extend so far as to permit the taxpayer to withhold from the government "records required to be kept by a valid regulation under the Price Control Act" at least "when there is a sufficient relation between the activity sought to be regulated and the public concern so that the government can constitutionally regulate or forbid the basic activity concerned, and can constitutionally require the keeping of particular records, subject to inspection by the Administrator" As to the relation of all this to tax returns and to records kept for tax purposes, see Meltzer, "Required Records, the McCarran Act, and the Privilege Against Self-Incrimination," 18 *U. of Chi. L. Rev.* 687, 708-819 (1951). See also *Falsone* v. *United States,* 205 F.2d 734 (5th Cir. 1953), stating that the privilege against self-incrimination does not extend to books kept pursuant to § 54(a) of the '39 Code [§ 6001, '54 Code]; Doyle, "Fraud Cases. Review of Law and Bureau Policy, Recent Cases, Opinions and Decisions," *12th Annual N.Y.U. Institute on Fed. Taxation* 1, 4-9 (1954), *United States* v *Kahriger*, 345 U.S 22(1953), sustaining the validity of the excise tax on persons engaged in the business of accepting wagers against objections based on the Fifth Amendment.

Section H. Imputed Income

VICKREY
AGENDA FOR PROGRESSIVE TAXATION

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I. Imputed Income from Assets

Home Ownership

Among the non-monetary items to be evaluated as part of income or spendings, the two most frequently mentioned are the rental value of owner-occupied homes and the value of homegrown produce consumed on the farm. Of these two the more important, in terms of securing an adequate progression of the tax, is imputed net rental. Home ownership tends to increase with increasing income, particularly in urban areas. However desirable home ownership may be as a

social institution, the omission of this imputed net rent from the present federal income tax base is hardly the most appropriate or the most effective method of promoting home ownership. Even if a subsidy of home ownership should be considered proper, this particular form is inefficient, for the subsidy is greatest at the top of the income scale where the need for such a stimulus is least.

Present Discriminations.—The discrimination involved in ignoring imputed net rent may be seen from the following example. *A* may rent his home with the $800 income he gets from $20,000 worth of securities, while *D* sells $10,000 of securities and buys a similar home with the proceeds, using the $400 income from his remaining securities to pay taxes and maintenance costs and to set aside against the depreciation of the property. With no tax, *A* and *D* are in the same position economically, but under the present federal tax law not only does *D* have only $400 to report as income as compared with *A*'s $800, but from that $400, *D* will be able to deduct that part used to pay property and other taxes on the home. . . .

Consumer Durables Generally

Miscellaneous Consumer Durables.—From imputed rental it is only a slight generalization to the problem of imputed income from the ownership of other durable consumer goods. The problem is essentially similar, although of smaller magnitude. Consider an individual *A* who has $25,000 of securities and uses the income to rent a furnished dwelling, as compared with a comparable individual *B* who uses the income from $20,000 of securities to rent an unfurnished dwelling, uses the proceeds from the sale of $3,000 worth of securities to buy furnishings and uses the income from the remaining $2,000 to replace the furnishings as they wear out. If no allowance is made for such income, *A* will pay a heavier tax than *B*. If the yield is 4%, *A* will have to pay tax on $1,000 a year, *B* on only $880, though there is no difference in their real situation such as would warrant such a tax differential. Similarly if *B* sells $1,000 worth of securities and buys a phonograph and records with the proceeds, while *A* uses the $40 annual income from the securities to buy tickets to concerts, *A* will pay more tax than *B*, though his real income is quite comparable.

All forms of durable consumer goods give rise to an imputed income in this way, although the discrimination is not so patent if the item in question is not commonly rented, and the services derived by the owner are of a type not comparable to any service commonly furnished separately.

Services of Debtors (Interest in Kind)

Bank Deposits.—In addition to the services of durable consumer goods as such, services in kind are sometimes rendered to the owners of certain types of assets in a way that is usually overlooked in determining income or consumption. One of the clearest cases of this is the service rendered by a bank to its depositors. For example, *A* may have a $500 bond, yielding $20 a year in interest and a checking account with little or no balance, so that he must pay the bank $20 a year in service charges. *B*, on the other hand, might sell the bond and deposit the proceeds, thus keeping a balance large enough so that there are no service charges to pay. Both *A* and *B* would be in the same economic position, but under usual methods of computing income, *B* would pay the smaller tax. . . .

Prepayments.—Another source of this type of imputed income is the purchase of goods or services in advance. Probably the most important instance of this is the purchase of fire and casualty insurance a year or more in advance. For example, *A* may purchase a five-year policy for $50, while *B* pays $12 annually for the same policy, or $2 a year more. Perhaps $1 of this difference may be due to economies in billing and the like, but about $1 per year will be the interest at about 4% on the average balance of $25, which *A* has invested in his policy. To equalize the tax on *A* and *B* it will be necessary to include in *A*'s income the $1 of interest earned on his deposit by the insurance company, which the insurance company presumably passes on to him in the form of insurance services and protection. . . .

III. Self-Service and Leisure

A taxpayer may not only consume some of the products he himself produces but he may also "consume" his own services. These services may or may not be the same as those he normally sells to others the principle involved is the same in either case, but the discrimination appears more distinctly when the services are of the same sort. For example, if a carpenter who has some carpentering to be done around his home were to stay home from his regular job a day or two to do it, then under the present income tax law, (and under most concepts of income which have been translated into statistics), we do not consider this work as producing any income either individually or nationally. On the other hand, if he were to stay at his regular job and hire another carpenter to do the work, his income is increased by the amount earned, although the real situation has not substantially altered. Obviously the value of the work done at home should in principle be added to the income. The same principle holds, though the case is not so striking, if an accountant stays at home to do some amateur plumbing instead of working and using his earnings to hire a professional plumber. In a modern industrial economy with division of labor carried to considerable lengths, such cases are not likely to be frequent enough to constitute a serious problem.

Housework of Wives

The really important case of consumption of one's own services is that of the housework done by wives. If two housewives were to agree to do each other's work for pay, the income reported under present laws would be greater than if they each do their own work. An arrangement of just that sort is rather infrequent, but there are a large number of cases where a wife will go to work and employ a servant to do the work she formerly did herself. For the wife to thus engage in "gainful" employment will increase the real family income only by the amount by which the wife's money earnings exceed the wages and keep of the servant. Where rates of tax are high and no allowance is made in the income tax base for income (or alternatively for expense) of this character the tax may seriously inhibit the entrance of married women into gainful occupations.

In wartime, when the manpower shortage is acute, the effects are serious. Even though the wife may require a full-or part-time servant if she goes to work, her productivity will often be greater than that of the servant or, at least, than her contributions as a housewife to the short-run output. In peacetime and particularly in time of unemployment there may be a plea that married women should

stay at home anyhow; but even if this objective were accepted, a tax differential of this sort is hardly a desirable method of bringing about this result. From a strictly economic point of view the discrimination is patent, and the effect on the national income and the general welfare may be substantial, some allowance, no matter how arbitrary, is imperative. Even though the measurement of either the imputed income from the wife's efforts in the case where she stays at home, or the expenses attributable to her remunerative employment be extremely difficult, the magnitude of the problem and the frequency with which it occurs demand that it be given close attention....

Objectives and Difficulties.—Fundamentally, the objective is to provide that if a wife is on the margin of deciding whether to take a job or to stay and do the housework the tax should not affect the decision; that is, the tax should be the same whichever she does. On this basis, one would either exempt from tax the minimum amount of the wife's earnings that would be necessary to persuade her to take a job, or add to the tax base of the non-working wife the maximum wage that could be offered without inducing her to take a job, or some equivalent combination of credit and imputed income would be required. The amount involved in such credits and additions would presumably vary with the other income of the family as well as with other factors. To attempt to determine such a quantity for each individual case would of course be completely impractical. On the other hand, to set up an arbitrary schedule related to family income would not be satisfactory either. The fundamental difficulty is that unless a tax is assessed on the imputed income from self-service and leisure in the case of single persons and husbands, or alternatively a very liberal earned income credit provided, any attempt to eliminate the effect of the tax on the employment of wives will necessarily involve discriminations and inconsistencies.

As an alternative, one might suggest the deduction from income of the expenses incurred because the wife works. But this is also unsatisfactory, for the line between expenses that really take the place of the services of the wife and the additional services that can be afforded because of the increased income of the family is extremely difficult to draw, even if the expenses arising as a result of the wife's decision to go to work can be segregated. Other adjustments than the provision of substitute services may be made. Alternative expenditures may be made in rather subtle ways. Groceries may be purchased by telephone from a store offering delivery service instead of at the "cash and carry"; meals may be eaten more often in restaurants; higher prices may be paid generally because of lack of time for leisurely shopping; quarters may be of a different type, etc....

The Non-Employed

The imputed income from the wife's industry has its counterpart in the case of the husband or single person who lives on a property income rather than from personal earnings. Though this difference is considerably less important in the aggregate amount involved, in the degree of choice open to the individual and in the importance of the difference to the individual, it merits consideration. In general, a person who voluntarily refrains from productive activity may be considered to be consuming his own services, or at least consuming his potential services in the form of leisure. At one extreme, this leisure may be valued at what the individual could earn by giving up the leisure and engaging in remunerative

employment. But to tax a person on what he could earn if he would (which is what this would amount to), instead of on what he actually does earn, is probably somewhat harsh, inasmuch as the tax is payable in money and the individual under those circumstances might well not have the wherewithal to pay the tax. Assessment of such a tax would be rather like levying a heavy fine for vagrancy, graduated according to the talents of the victim, with the likelihood that alternative penalties might have to be invoked. In practice this issue is not likely to be taken up, since it may be extremely difficult to determine when idleness is voluntary (or perverse) and hence indicative of an imputed leisure income, and when it is involuntary and decidedly not productive of imputed income. There is already sufficient difficulty in distinguishing between voluntary and involuntary unemployment in the occupationally fairly well-defined groups of people covered by unemployment compensation. the difficulties of extending this to miscellaneous occupations, professions, and trades would be considerable.

But without attempting to evaluate leisure as such, there is a very real and concrete sense in which the cost of living of the gainfully occupied may exceed that of the individual who lives on property income exclusively. The employed person is under the necessity of living near his place of work, which in many cases means increased cost of housing. He usually has certain expenses for carfare to and from work, for clothing suitable to the work, and possibly other incidental items which cannot well be allowed as specific deductions from gross income. Particularly if he is single, he will probably have to pay to have certain services such as laundry, household cleaning, and possibly cooking done for him which he might, if at leisure, do for himself in his free time. Again, if single, he will probably spend more for food, being unable to prepare it himself, and whether married or single may have to spend more for lunches and so on. Shopping may be done in a more hurried and less thrifty fashion. Thus even in a strict monetary sense, there is a substantial difference in the real income of a person who earns an income and one who obtains the same money income from property.

Note

The value of certain untaxed items of imputed income is estimated, in determining gross national output, in *National Income:* 1951 Edition (U.S. Department of Commerce) 55–144. While the estimates are often based on limited data and do not purport to state the amount by which taxable income would be increased if imputed income were taxable, they are still of interest The net rental value of owner-occupied nonfarm dwellings is estimated at \$2 6 billion and imputed interest received by persons and businesses at \$2 1 billion. The value of produce consumed at home by farmers is estimated at \$3.1 billion and the rental value of owner-occupied farm dwellings at \$1.2 billion; these are gross amounts, however, and the net amounts (*i.e*, gross less allocable expenses) are not separately estimated.

Apparently the only Supreme Court comment on the taxation of imputed income is in *Helvering* v. *Independent Life Ins. Co*, 292 U.S. 371 (1934), involving § 245(b) of the Revenue Act of 1921, the predecessor of § 803(h) of the 1954 Code. In the case of real estate owned and occupied by a life insurance company, maintenance expenses, taxes, and depreciation could be deducted only if the taxpayer included in income the rental value of the real estate. The Court held that since deductions are a matter of legislative grace, Congress might qualify any deduction that it chose to allow. If the taxpayer did not wish to take the deductions, it was not required to include the rental value in income; thus, the rental value operated simply as a limitation on deductions

that Congress could have denied entirely The Court also said, however, that a tax on the rental value of a building (*i.e.*, if the taxpayer were *required* to include the rental value in income) would be a "direct" tax within the meaning of Article 1, Section 9, Clause 4 of the Constitution, valid only if apportioned among the states in proportion to population, and that it was not excused from the requirement of apportionment by the Sixteenth Amendment, because the rental value of a building occupied by its owner is not "income."

Section 1087*m*-2(a) of the Wisconsin Income Tax Law of 1911 provided that "the term 'income' shall include . . estimated rental of residence property occupied by the owner." This provision was upheld in *Income Tax Cases*, 148 Wis. 456, 134 N.W. 673, 135 N.W. 164 (1912). The United States Supreme Court dismissed a writ of error on procedural grounds and refused to comment on the substantive issue involved. *Bolens* v. *Wisconsin*, 231 U S. 616 (1914). In the Revenue Acts of 1864, 1865, 1867, and 1870, Congress specifically rejected recommendations by the Commissioner of Internal Revenue that the "rental value of any homestead used or occupied by any person, or by his family, . . be included and assessed as part of the income of such person." 13 U S. Stat. 281 (1864), *id.* at 478 (1865), 14 *id.* at 478 (1867), 16 *id.* at 258 (1870), see Smith, *The United States Federal Internal Tax History from 1861-1870* at 58, 62, 76 (1914).

See also Marsh, "The Taxation of Imputed Income," 58 *Pol. Sci. Q.* 514 (1943).

CHAPTER 2

THE INDIVIDUAL, NON-BUSINESS TAXPAYER

Section A. Non-Taxable Items

Chapter 1 was concerned with the "outer limits" of federal income taxation. There we saw, among other things, that not everything that comes in is income. Some of the exempt items were found to be immune on constitutional grounds, though others were protected on the theory that Congress did not intend to tax them and others perhaps only because the rulings or decisions concerning them have not been challenged in recent years. At any rate, Chapter 1's exempt items were not placed beyond the tax collector's reach by any specific statutory exemption.

Now we will examine a variety of specific statutory exemptions. For the most part, these exemptions apply to items that would otherwise be taxable; but in some cases the exemption was originally enacted because the item in question was thought to be constitutionally immune to tax, and the continued existence of the statutory exemption has made it unnecessary for the courts to pass on the constitutional issue.

1. Gifts

Note: Section 22(b)(3) of the 1939 Code excluded from gross income "the value of property acquired by gift, bequest, devise, or inheritance," and § 113(a)(2) (involved in *Taft* v. *Bowers, supra,* p. 81) prescribed how the "basis" of property acquired by gift should be determined. These sections were carried over as §§ 102 and 1015 of the 1954 Code, without substantive change. Certain questions that were troublesome under § 22(b)(3) of the 1939 Code — the treatment of prizes and scholarships — are now dealt with specifically by the statute: Sections 74 (prizes and awards) and 117 (scholarships and fellowships).

See Regs. 118, Secs. 39.22(a)-2(a), 39.22(b)(3)-1, 39.23(a)-8, and 39.113(a)(2)-1.

FARID-ES-SULTANEH v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1947

160 F.2d 812

Before SWAN, CHASE, and CLARK, Circuit Judges.

CHASE, Circuit Judge.

The problem presented by this petition is to fix the cost basis to be used by the

petitioner in determining the taxable gain on a sale she made in 1938 of shares of corporate stock. She contends that it is the adjusted value of the shares at the date she acquired them because her acquisition was by purchase. The Commissioner's position is that she must use the adjusted cost basis of her transferor because her acquisition was by gift. The Tax Court agreed with the Commissioner and redetermined the deficiency accordingly.

The pertinent facts are not in dispute and were found by the Tax Court as they were disclosed in the stipulation of the parties substantially as follows:

The petitioner is an American citizen who filed her income tax return for the calendar year 1938 with the Collector of Internal Revenue for the Third District of New York and in it reported sales during that year of 12,000 shares of the common stock of the S. S. Kresge Company at varying prices per share, for the total sum of $230,802.36 which admittedly was in excess of their cost to her. How much this excess amounted to for tax purposes depends upon the legal significance of the facts now to be stated.

In December 1923 when the petitioner, then unmarried, and S. S. Kresge, then married, were contemplating their future marriage, he delivered to her 700 shares of the common stock of the S. S. Kresge Company which then had a fair market value of $290 per share. The shares were all in street form and were to be held by the petitioner "for her benefit and protection in the event that the said Kresge should die prior to the contemplated marriage between the petitioner and said Kresge." The latter was divorced from his wife on January 9, 1924, and on or about January 23, 1924 he delivered to the petitioner 1800 additional common shares of S. S. Kresge Company which were also in street form and were to be held by the petitioner for the same purposes as were the first 700 shares he had delivered to her. On April 24, 1924, and when the petitioner still retained the possession of the stock so delivered to her, she and Mr. Kresge executed a written ante-nuptial agreement wherein she acknowledged the receipt of the shares "as a gift made by the said Sebastian S. Kresge, pursuant to this indenture, and as an ante-nuptial settlement, and in consideration of said gift and said ante-nuptial settlement, in consideration of the promise of said Sebastian S. Kresge to marry her, and in further consideration of the consummation of said promised marriage" she released all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife. They were married in New York immediately after the ante-nuptial agreement was executed and continued to be husband and wife until the petitioner obtained a final decree of absolute divorce from him on, or about, May 18, 1928. No alimony was claimed by, or awarded to, her.

The stock so obtained by the petitioner from Mr. Kresge had a fair market value of $315 per share on April 24, 1924, and of $330 per share on or about May 6, 1924, when it was transferred to her on the books of the corporation. She held all of it for about three years, but how much she continued to hold thereafter is not disclosed except as that may be shown by her sales in 1938. Meanwhile her holdings had been increased by a stock dividend of 50 per cent, declared on April 1, 1925; one of 10 to 1 declared on January 19, 1926, and one of 50 per cent, declared on March 1, 1929. Her adjusted basis for the stock she sold in 1938 was $10.66⅔ per share computed on the basis of the fair market value of the shares which she

obtained from Mr. Kresge at the time of her acquisition. His adjusted basis for the shares she sold in 1938 would have been $0.159091.

When the petitioner and Mr. Kresge were married he was 57 years old with a life expectancy of 16½ years. She was then 32 years of age with a life expectancy of 33¾ years. He was then worth approximately $375,000,000 and owned real estate of the approximate value of $100,000,000.

The Commissioner determined the deficiency on the ground that the petitioner's stock obtained as above stated was acquired by gift within the meaning of that word as used in § 113(a) (2) of the Revenue Act of 1938 [§ 1015(a), 1954 Internal Revenue Code], and, as the transfer to her was after December 31, 1920, used as the basis for determining the gain on her sale of it the basis it would have had in the hands of the donor. This was correct if the just mentioned statute is applicable, and the Tax Court held it was on the authority of *Wemyss* v. *Commissioner*, 324 U.S. 303, 65 S. Ct. 652, 89 L. Ed. 958, 156 A.L.R. 1022, and *Merrill* v. *Fahs*, 324 U.S. 308, 65 S. Ct. 655, 89 L. Ed. 963.

The issue here presented cannot, however, be adequately dealt with quite so summarily. The *Wemyss* case determined the taxability to the transferor as a gift, under §§ 1000(b) and 1002 of the Internal Revenue Code [§§ 2511(a) and 2512 (b), '54 Code], and the applicable regulations, of property transferred in trust for the benefit of the prospective wife of the transferor pursuant to the terms of an ante-nuptial agreement. It was held that the transfer, being solely in consideration of her promise of marriage, and to compensate her for loss of trust income which would cease upon her marriage, was not for an adequate and full consideration in money or money's worth within the meaning of § 1002 of the statute, the Tax Court having found that the transfer was not one at arm's length made in the ordinary course of business. But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is *ipso facto* to be treated as a gift in construing the income tax law.

In *Merrill* v. *Fahs*, *supra*, it was pointed out that the estate and gift tax statutes are in *pari materia* and are to be so construed. *Estate of Sanford* v. *Commissioner of Internal Revenue*, 308 U.S. 39, 44, 60 S. Ct. 51, 84 L. Ed. 20. The estate tax provisions in the Revenue Act of 1916 required the inclusion in a decedent's gross estate of transfers made in contemplation of death, or intended to take effect in possession and enjoyment at or after death except when a transfer was the result of a "bona fide sale for a fair consideration in money or money's worth." Sec. 202(b), 39 Stat. 756, 777. The first gift tax became effective in 1924, and provided *inter alia*, that where an exchange or sale of property was for less than a fair consideration in money or money's worth the excess should be taxed as a gift. Rev. Act of 1924, § 320, 43 Stat. 314, 26 U.S.C.A. Int. Rev. Acts, page 81. While both taxing statutes thus provided, it was held that a release of dower rights was a fair consideration in money or money's worth. *Ferguson* v. *Dickson*, 3 Cir., 300 F. 961, certiorari denied 266 U.S. 628, 45 S. Ct. 126, 69 L. Ed. 476; *McCaughn* v. *Carver*, 3 Cir., 19 F.2d 126. Following that, Congress in 1926 replaced the words "fair consideration" in the 1924 Act limiting the deductibility of claims against an estate with the words "adequate and full consideration in money or money's worth" and in 1932 the gift tax statute as enacted limited consideration in the same way. Rev. Act 1932, § 503. Although Congress in 1932 also expressly

provided that the release of marital rights should not be treated as a consideration in money or money's worth in administering the estate tax law, Rev. Act of 1932, § 804, 26 U.S.C.A. Int. Rev. Acts, page 642, and failed to include such a provision in the gift tax statute, it was held that the gift tax law should be construed to the same effect. *Merrill* v. *Fahs, supra.*

We find in this decision no indication, however, that the term "gift" as used in the income tax statute should be construed to include a transfer which, if made when the gift tax were effective, would be taxable to the transferor as a gift merely because of the special provisions in the gift tax statute defining and restricting consideration for gift tax purposes. *A fortiori,* it would seem that limitations found in the estate tax law upon according the usual legal effect to proof that a transfer was made for a fair consideration should not be imported into the income tax law except by action of Congress.

In our opinion the income tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes. They are aimed at the gathering of revenue by taking for public use given percentages of what the statute fixes as net taxable income. Capital gains and losses are, to the required or permitted extent, factors in determining net taxable income. What is known as the basis for computing gain or loss on transfers of property is established by statute in those instances when the resulting gain or loss is recognized for income tax purposes and the basis for succeeding sales or exchanges will, theoretically at least, level off tax-wise any hills and valleys in the consideration passing either way on previous sales or exchanges. When Congress provided that gifts should not be treated as taxable income to the donee there was, without any correlative provisions fixing the basis of the gift to the donee, a loophole which enabled the donee to make a subsequent transfer of the property and take as the basis for computing gain or loss its value when the gift was made. Thus it was possible to exclude from taxation any increment in value during the donor's holding and the donee might take advantage of any shrinkage in such increment after the acquisition by gift in computing gain or loss upon a subsequent sale or exchange. It was to close this loophole that Congress provided that the donee should take the donor's basis when property was transferred by gift. Report of Ways and Means Committee (No. 350, P. 9, 67th Cong., 1st Sess.). This change in the statute affected only the statutory net taxable income. The altered statute prevented a transfer by gift from creating any change in the basis of the property in computing gain or loss on any future transfer. In any individual instance the change in the statute would but postpone taxation and presumably would have little effect on the total volume of income tax revenue derived over a long period of time and from many taxpayers. Because of this we think that a transfer which would be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise. Though such a consideration as this petitioner gave for the shares of stock she acquired from Mr. Kresge might not have relieved him from liability for a gift tax, had the present gift tax then been in effect, it was nevertheless a fair consideration which prevented her taking the shares as a gift under the income tax law since it precluded the existence of a donative intent.

Although the transfers of the stock made both in December 1923, and in the following January by Mr. Kresge to this taxpayer are called a gift in the antenuptial agreement later executed and were to be for the protection of his prospec-

tive bride if he died before the marriage was consummated, the "gift" was contingent upon his death before such marriage, an event that did not occur. Consequently, it would appear that no absolute gift was made before the antenuptial contract was executed and that she took title to the stock under its terms, *viz:* in consideration for her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage. Her inchoate interest in the property of her affianced husband greatly exceeded the value of the stock transferred to her. It was a fair consideration under ordinary legal concepts of that term for the transfers of the stock by him. *Ferguson* v. *Dickson, supra; McCaughn* v. *Carver, supra.* She performed the contract under the terms of which the stock was transferred to her and held the shares not as a donee but as a purchaser for a fair consideration.

As the decisive issue is one of law only, the decision of the Tax Court interpreting the applicable statutory provisions has no peculiar finality and is reviewable. *Bingham* v. *Commissioner,* 325 U.S. 365, 65 S. Ct. 1232, 89 L. Ed. 1670.

Decision reversed.

CLARK, Circuit Judge *(dissenting).*

The opinion accepts two assumptions, both necessary to the result. The first is that definitions of gift under the gift and estate tax statutes are not useful, in fact are directly opposed to, definitions of gift under the capital-gains provision of the income tax statute. The second is that the circumstances here of a transfer of the stock some months before the marriage showed, contrary to the conclusions of the Tax Court, a purchase of dower rights, rather than a gift. The first I regard as doubtful, the second, as untenable.

It is true that *Commissioner of Internal Revenue* v. *Wemyss,* 324 U.S. 303, 65 S. Ct. 652, 89 L. Ed. 958, 156 A.L.R. 1022, and *Merrill* v. *Fahs,* 324 U.S. 308, 65 S. Ct. 655, 89 L. Ed. 963, which would require the transactions here to be considered a gift, dealt with estate and gift taxes. But no strong reason has been advanced why what is a gift under certain sections of the Revenue Code should not be a gift under yet another section. As a matter of fact these two cases indicate that the donative intent of the common law is not an essential ingredient of a gift for tax purposes. Conversely love, affection, and the promise of future marriage will not be consideration adequate to avoid the gift tax. If that is so, it would seem that these should not be sufficient to furnish new and higher cost bases for computing capital gains on ultimate sale. The Congressional purpose would seem substantially identical—to prevent a gap in the law whereby taxes on gifts or on capital gains could be avoided or reduced by judicious transfers within the family or intimate group.

But decision on that point might well be postponed, since, to my mind, the other point should be decisive. Kresge transferred the stock to petitioner more than three months before their marriage. Part was given when Kresge was married to another woman. At these times petitioner had no dower or other rights in his property. If Kresge died before the wedding, she could never secure dower rights in his lands. Yet she would nevertheless keep the stock. Indeed the specifically stated purpose of the transfer was to protect her against his death prior to marriage. It is therefore difficult to perceive how her not yet acquired rights could be consideration for the stock. Apparently the parties themselves shared

this difficulty, for in their subsequent instrument releasing dower rights they referred to the stock transfer as a gift and an antenuptial settlement.

If the transfer be thus considered a sale, as the majority hold, it would seem to follow necessarily that this valuable consideration (equivalent to one-third for life in land valued at one hundred million dollars) should have yielded sizable taxable capital gains to Kresge, as well as a capital loss to petitioner when eventually she sold. I suggest these considerations as pointing to the unreality of holding as a sale what seems clearly only intended as a stimulating cause to eventual matrimony.

Since Judge Murdock in the Tax Court found this to be a gift, not a sale, and since this decision is based in part at least upon factual considerations, it would seem binding upon us. At any rate, it should be persuasive of the result we ought to reach.

Note

Does a wife realize taxable income when her husband supports her? Support (to the extent required by law) is not a "gift" for gift tax purposes. If the gift tax definition of "gift" were adopted for income tax purposes, would support be income to the wife? If a fond but abstemious uncle promises his nephew $5,000 if he neither drinks nor smokes before the age of 21, will the payment be income to the nephew?

Why are gifts immune from income tax? See Simons, *Personal Income Taxation* (1939) 125-147.

BAUSCH'S ESTATE v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1951
186 F.2d 313

Before L. HAND, Chief Judge and SWAN and AUGUSTUS N HAND, Circuit Judges.

AUGUSTUS N. HAND, Circuit Judge.

These petitions were to review deficiencies found by the Tax Court in the income taxes of the Estates of Edward Bausch and William Bausch. The underlying facts, as found by the Tax Court, are not in dispute. The taxpayers are the executors of these respective estates. Each of the decedents had been in the employ of Bausch & Lomb Optical Company upwards of fifty years. Edward Bausch had been vice-president for many years, and finally became president and subsequently chairman of the board. William Bausch, who was for a long time secretary of the company, in 1935 became vice-president and succeeded Edward Bausch as chairman of the board, upon the latter's death. Each was receiving a salary of $1500 per month at the time of his death. The company paid to the estate of each decedent the sum of $1500 per month for a period of twelve months following his death. Edward Bausch left as his closest surviving relatives his brother, William Bausch, his sister, and three nieces and a nephew. William Bausch left as his closest surviving relatives the same sister, nieces and nephew. Edward Bausch left a will under which, after providing specific bequests to various individuals and charitable corporations, he bequeathed the residue of his estate four-fifths to his nieces and nephew and one-fifth to the nephews and nieces of his deceased wife. William Bausch made specific bequests to various individuals and charitable corporations and gave the residue of his estate in equal shares to his nieces and nephew and to a nephew of his deceased wife.

The company had made similar payments to the heirs or estates of deceased officers in the past. There was no agreement between the company and Edward or William Bausch to make the payments in question. The decision to make them was made by the president and treasurer and other principal officers, but the board of directors adopted no resolution relating to the payments here in question. The company deducted them from its income tax returns for the years in which such payments were made.

It was found that the payments to the Estates of Edward Bausch and William Bausch were made because the company had paid a year's salary to the widow of one former vice-president, who died December 30, 1936, and to the estate of another vice-president who died in 1939. These four officers had all been with the company for over fifty years and had been largely responsible for its growth. It was therefore thought reasonable to do as well for the estates of Edward Bausch and William Bausch as in the case of the first two.

The question before us is whether the foregoing payments constituted taxable income to the petitioners under Sections 22(a) and 126 of the Internal Revenue Code, or were gifts under Section 22(b) (3), 26 U.S.C.A. §§ 22(a, b) (3), 126. The fact that they were voluntary and could not have been enforced by action did not necessarily render them gifts within the meaning of Section 22(b) (3). *Old Colony Trust Co.* v. *Commissioner of Internal Revenue,* 279 U.S. 716, 730, 49 S. Ct. 449, 73 L. Ed. 918. If they were "compensation for personal services" they were taxable under the express terms of Section 22(a). Here the payments were deducted from the income tax returns of the corporation in the years in which they were paid; it had become a practice of the company to recompense the estates or dependents of deceased founders; the payments were measured by the salary paid each decedent during the year prior to his death; from such undisputed facts there would seem to be a reasonable inference that the payments were a reward for past services, and so the determination of the Tax Court should be upheld. *Fisher* v. *Commissioner of Internal Revenue,* 2 Cir. 59 F.2d 192, 193.

The taxpayer relies on I.T. 3329, 1939-2 C.B. 153, which ruled that the salary of a deceased officer, if continued for a limited period and paid to his widow, would be deductible by the corporation as a business expense but nevertheless would be a non-taxable gift in her hands. The reason given was that "when an allowance is paid by an organization to which the recipient has rendered no service, the amount is deemed to be a gift or gratuity and is not subject to federal income tax in the hands of the recipient." I.T. 3329, has been recently modified, however, so as to apply only to the situation where no services have been rendered to the employer either by the recipient or anybody else. I T. 4027, 1950-2 Int. Rev. Bull. 9. In the case at bar the payments were a reward for services performed for the employer. That alone should be enough to render the payments taxable but in any event they were made to the executors of the deceased employees of the company who in contemplation of law continued the legal personalities of the employees and were specifically taxed under Sec. 126(a) [1] upon receipts for services by their

[1] "The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; . . ." [See Craven, "Taxation of Income of Decedents," 102 *U. of Pa. L. Rev.* 185 (1953); Note, 65 *Harv. L. Rev.* 1024 (1952). The basic principle of § 126 of the 1939 Code is carried over by § 691 of the 1954 Code. Ed]

testators. Though the correctness of the ruling as to widows in I.T. 3329 would seem doubtful if applied to all cases, it is unnecessary to consider under what circumstances sums paid to a widow or to other persons might be mere gifts and nothing more, for the payments here were by way of compensation rather than gifts and, therefore, were properly includible in the estates of the decedents under Section 126(a). *O'Daniel's Estate* v. *Commissioner of Internal Revenue*, 2 Cir., 173 F.2d 966.

For the foregoing reasons the decisions of the Tax Court holding the payments taxable income and sustaining the deficiencies are affirmed.

Note

1. Is it possible for an employer to make a "gift" to a retiring employee "not for services . . . but out of affection, respect, admiration, charity or like impulses?" (*Robertson* v. *United States*, *infra*, p. 123.) See *Schall* v *Commissioner*, 174 F.2d 893 (5th Cir. 1949), *Abernethy* v. *Commissioner*, 211 F 2d 651 (D C Cir 1954); *Dewling* v. *United States*, 101 F. Supp 892 (Ct. Cl. 1952), Chommie, "Payments to Employees Gifts or Compensation for Services," 31 *Taxes* 620 (1953).

2. Note that Regs 118, Sec. 39.22(a)-2(a), provides that "so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable." As the *Bausch* case points out, this provision of the Regulations had been interpreted to exempt payments to the widow of a deceased employee, since she had rendered no services. The later ruling cited in the *Bausch* opinion restricts the exemption to situations where neither the recipient nor anyone else rendered services to the payor. What payments will continue to enjoy the exemption?

3 Shortly after the *Bausch* case was decided, the Revenue Act of 1951 added § 22(b)(1)(B) to the Code, excluding from income amounts, not to exceed $5000, paid under stated conditions by an employer to the beneficiaries of a deceased employee. This provision now appears, somewhat modified, as § 101(b) of the 1954 Code.

4. Tips are income, *Roberts* v. *Commissioner*, 176 F.2d 221 (9th Cir. 1949), and so are "contributions" (stimulated by the fear of being accused of stinginess) to a city clerk for performing marriage ceremonies, *United States* v. *McCormick*, 67 F.2d 867 (2d Cir. 1933). The following is from the New Haven Sunday Register for March 8, 1953:

BRUNETTE HELD ON TAX CHARGES; SELDOM WORKED

Birmingham, Ala. March 7—(AP)—A pretty, 32-year-old brunette, who said, "I entertained guys," was charged with failing to file income tax returns on an income of almost $50,000.

Miss Jessie Ruth Chesnutt was arraigned before U.S Commissioner Louise O. Carlton yesterday and released under $500 bond.

Her attorney, Robert Gwin, contended "that Miss Chesnutt's income is not taxable in that the money she has was given to her in the form of gifts."

He later told reporters the funds "were given her by various individuals over a period of years."

Asked if the gifts were from men or women, Miss Chesnutt said "Gentlemen, naturally."

"I never did any kind of work much," she continued. "I did work in a cotton mill and on a farm and I entertained guys."

Miss Chesnutt said she was a native of Gadsden, Ala., and had also lived in Las Vegas, Reno and Detroit.

A Federal warrant against her charged she failed to file income tax returns on an income of $11,985 in 1949, $25,644 in 1950 and $12,144 in 1951.

The Government filed an $83,000 tax lien again Miss Chesnutt's property. Gwin said $60,000 of her property was in defense bonds.

The solicitor's office here said Miss Chesnutt has been arrested three times on disorderly conduct charges.

COMMISSIONER v. JACOBSON

Supreme Court of the U.S., 1949
336 U.S. 28

Mr. Justice Burton delivered the opinion of the Court.

This decision applies the federal income tax to gains derived by a debtor from his purchase of his own obligations at a discount and his consequent control over their discharge. It presents the specific question whether a solvent natural person, in straitened financial circumstances, must include in his gross income for federal income tax purposes the difference between (1) the face amount of his personal indebtedness as the maker of secured bonds, originally issued by him at face value for cash, and (2) a lesser amount paid by him for their purchase. The debtor's obligations were not unpaid balances of purchase prices which could be readjusted by the discharge of the obligations. The proceeds of the obligations were not traced into identifiable losses offsetting the debtor's realized gains from the discharge of these obligations. Each seller knew that the bonds he sold were being bought by or for the maker of them. In each sale the bondholder sought to minimize his probable loss by getting as much as possible, directly or indirectly, from the maker of the bonds as the one available purchaser of them. The maker of the bonds, at the same time sought to reduce his obligations as much as possible by buying the bonds as cheaply as he could. While each seller thus knew that he was receiving from the maker of the bonds less than their face amount, there is no finding that any seller intended to transfer or release something for nothing or to make a gift of any part of his claim, as distinguished from making a sale and assignment of his whole claim for the highest available price. The maker thus realized a gain from each purchase and the Commissioner of Internal Revenue found correctly that, for federal income tax purposes, the maker must include that gain in his gross income for the tax year in which he made the purchase.

The respondent, Lewis F. Jacobson, in 1938, 1939 and 1940 resided, practiced law and owned or controlled substantial property interests in Chicago, Illinois. . . .

By purchases made in 1922 and 1923 the respondent acquired a 99-year lease, running from May 1, 1914, together with a two-story store, office and apartment building on the leased premises in Chicago. On or about May 1, 1925, he borrowed $90,000 from a nearby bank and, together with his wife, executed in return 200 bonds secured by a trust deed mortgaging to that bank the leasehold and the improvements thereon. The bonds bore interest at 6½ per cent per annum and were for the total principal amount of $90,000, with $2,500 maturing semiannually up to and including November 1, 1931. The balance of the bonds, totalling $57,500, were to mature May 1, 1932. The original proceeds were used by the respondent to retire the existing encumbrance, of an undisclosed amount, on the property, pay for a $16,250 addition made by him to the building on the leasehold and pay the necessary brokerage commission of approximately 10 per cent of the loan, plus the cost of printing the bonds and other expenses in connection with the loan. . . .

The bonds due on or before November 1, 1931, were paid at or about their maturities. The debtor has never been in default on any interest payment. However, after the trustee bank closed on June 8, 1931, a committee was formed to

represent the holders of this issue of bonds. May 1, 1932, the respondent secured from the committee and individual bondholders a five-year extension of the maturity on all of the bonds and a reduction in the interest rate from 6½ to 5 per cent....

In his petition to the Tax Court the respondent stated, and it has not been disputed, that the value of the leasehold and building had sharply depreciated since his acquisition of them. The neighborhood had changed, stores were vacant or paid less than half of their previous rents, from 1932 to 1938 the value of the property was substantially less than its cost to him, conditions were getting worse and he felt certain that he would sustain a large loss in connection with the property.

The Tax Court's findings describe each bond sale that is material. Some were to the respondent personally and some to his law partner, acting on his behalf. The rest were made indirectly to the respondent through brokers or through the bondholders' committee. The Tax Court said that each sale that was made through a broker or the committee was closely akin to an open market transaction. It made no finding that any seller intended to transfer or release something for nothing. It referred to all of the respondent's acquisitions of bonds as purchases. Apparently the bonds were payable to bearer and the Tax Court referred to them as negotiable bonds. Each seller made a complete transfer to the respondent of all the seller's rights to or under the bonds. Each seller thus determined the amount of his own loss on his investment. Each knew that the maker of the bond would acquire or secure control over it and would thus be enabled to reduce his liabilities by its face amount.... At the time of the trial, the respondent apparently still held the purchased bonds "intact." The Court of Appeals repudiated any distinction made by the Tax Court for present purposes between the direct and indirect sales to the respondent. The Court of Appeals based its decision on each seller's knowledge that he was transferring his bond to the maker of it. Thus far we agree. The Court of Appeals, however, without any finding of intent by the respective sellers to transfer or release something for nothing, as distinguished from an intent to get the highest available price for their entire claims, treated the respondent's gain from each purchase as exempt from the taxation imposed by § 22(a) of the Revenue Act of 1938 and of the Internal Revenue Code, because that court felt itself obliged by precedent to classify each such gain as a "gift" under § 22(b) (3) of that Act and Code. We hold, however, that those Sections do not, in the light of the decisions of this Court, permit that result.

The first test of the taxability of such gains relates to their inclusion within the gross income of the taxpayer under § 22(a), without reference to the specific exclusions made from it by § 22(b). The other test consists of the application to such gains of any of those specific exclusions. We hold that these gains come within § 22(a) but not within any of the exclusions from gross income stated in § 22(b).

The respondent realized an immediate financial gain from his purchase of these bonds at a discount. By that acquisition he was enabled, at will, to cancel them and thus discharge himself from liability to pay them. . . . Although in straitened financial circumstances he was solvent, both before and after his acquisition of the bonds, and the bonds apparently were collectible from him in full

through appropriate enforcement proceedings. His acquisition, and consequent control over the discharge of these bonds, therefore, improved his net worth by the difference between their face amount and the price he paid for them. It also relieved him of the semiannual interest payments on them of 5 per cent per annum. His acquisition of them likewise reduced the face amount of the lien held by others upon his leasehold property. In the first instance he had received the full face amount in cash for these bonds so that his repurchase of them for 50 per cent, or less, of that amount reflected a substantial benefit which he had derived from the use of that borrowed money. These were not purchase money bonds. The gains from their cancellation were not akin to reductions in balances due on the prices of previously acquired property. The respective sellers of the bonds bore no relation to the respondent other than that of creditors. The gains derived by the respondent through these purchases were comparable to those he would have realized if he had purchased, at the same discount, like bonds issued by a third party and had resold them at full face value or had turned them in at full value as a credit upon some other indebtedness of the respondent. His gains were comparable in their nature to those which he would have realized if a third party, pursuant to a contract, had paid off his indebtedness on these bonds for him to the extent of the discount at which he purchased them. The nature of the gain derived by a debtor from his purchase of his own obligations at a discount is the same whether the debtor is a corporation or a natural person. That such a gain comes within the meaning of gross income as used in federal income tax laws was long ago recognized by the Treasury Department's Regulations and by this Court in the leading cases in this field. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131; *Helvering* v. *American Chicle Co.*, 291 U.S. 426, 54 S. Ct. 460, 78 L. Ed. 891. Similar provisions appeared in the Regulations in effect in 1938–1940.

If § 22(a) stood alone, without the exclusions stated in § 22(b), the gain realized by the respondent in this case unquestionably would constitute gross income for income tax purposes. The provisions of § 22(b) and the decisions of this Court do not change that result. On the contrary, they confirm it.

A striking demonstration of the meaning given by Congress to § 22(a) appears in its Amendments to § 22(b) of the Internal Revenue Code by the Revenue Act of 1939, c. 247, 53 Stat. 862, approved June 29, 1939.* These Amendments then applied only to taxable years beginning after December 31, 1938, and only to discharges of indebtedness occurring on or after June 29, 1939. The value of these Amendments for the purposes of the instant case is not so much in the exclusions which they prescribe, as in the clear light which their own limitations shed upon §§ 22(a) and 22(b) to the extent that those Sections remain unchanged.

Unless those Sections as they stood in 1938 meant that the gains derived by a

* The 1939 amendment to § 22(b) was § 22(b)(9) of the 1939 Code, providing that a corporation might exclude from gross income the amount of any income "attributable to the discharge . . . of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security," providing the taxpayer consented to a reduction of the basis of its property (*i e.*, the basis of its property would be reduced, for calculating depreciation and gain or loss on a sale, by the amount of the cancelled debt) under § 113(b)(3). The corresponding sections of the 1954 Code, modified to eliminate the requirement that the debt be evidenced by a security and to include the indebtedness of an individual if incurred or assumed in connection with property used in his trade or business, are §§ 108 and 1017. [Ed.]

debtor corporation from its purchases of its own obligations at a discount resulted in gross income under § 22(a), there was no need for these 1939 Amendments. Furthermore, as the status of natural persons and corporations is not differentiated in § 22(a), the new Amendments make it equally clear that, inasmuch as they relieve only certain corporations from the taxability of gains derived from their purchases of their own obligations at a discount, it must be that similar gains derived by natural persons also remain taxable under § 22(a). The strength of this reflection of the Amendments upon the unamended Sections is emphasized by their temporary character. The Amendments expressly provide that they shall not apply to a taxable year beginning after December 31, 1942. This indicates that, for its permanent program, Congress regarded such gains as properly taxable and it indicates that the Amendments were intended to authorize temporary changes in policy and were not clarifications of existing or continuing tax policies. While the time limit originally prescribed has been subsequently extended, the extensions have been made by separate Acts, each for a period of one to three years. This repeated emphasis upon their temporary character increases the contrast which they make with the permanent policy of Congress as to the general taxability of this kind of gains under § 22(a) †

These Amendments describe gains corresponding almost precisely with those derived by the respondent from his transactions in the instant case but the Amendments apply only to corporate gains. They thus indicate that such gains were recognized as not having been excluded from gross income by § 22(b) (3) or by any other Section. If they had been so excluded there would have been no need for the new Amendments to exclude those which they did, even temporarily. Furthermore, those gains are not excluded from gross income for all purposes of the income tax laws. Section 22(b) (9) excludes them only from the ordinary income taxes for the taxable year in which the taxpaying corporation purchases its own securities at a discount. Furthermore, the exclusion under § 22(b) (9), as distinguished from other exclusions under § 22(b), is available only upon the express condition that the taxpayer makes and files at the time of filing the return its consent to the Regulations prescribed under § 113(b)(3) then in effect. That Section and such Regulations require that, where any amount is excluded by a corporation from its gross income under § 22(b) (9) on account of its discharge of its own indebtedness, the whole or a part of such amount shall be applied to the reduction of the basis of property held by the taxpayer during any portion of the taxable year in which such discharge occurs The amount to be so applied and the properties to which the reduction shall be allocated are to be determined by Regulations approved by the Secretary of the Treasury. This means that such a gain, instead of being completely excluded as exempt from taxation, is postponed, for income tax purposes, until a later date when the property is disposed of in a way which will permit another form of ascertainment of the taxpayer's gain or loss in its disposition. These provisions therefore demonstrate that Congress, at least since 1939, has prescribed that, in order for a corporate taxpayer to exclude from its gross income under § 22(a) certain gains attributable to the discharge within the tax-

† After a number of successive extensions for limited periods, the time limit was dropped. [Ed.]

able year of the taxpayer's indebtedness evidenced by bonds, the taxpayer must consent to the subsequent use of those gains in reducing the basis of property held by the taxpayer during any portion of the taxable year in which such discharge occurred. A corporate taxpayer with gains meeting these specifications but not filing the required consent would be obliged to include those gains in its gross income, unless additional facts brought them under some other exemption. *A fortiori*, a natural person, such as the respondent in the instant case, who has derived gains precisely within these specifications but who, as a natural person, is ineligible to file the required consent is obliged to include those gains in his gross income under § 22(a). It remains, therefore, to consider whether there are facts in this case which bring this respondent's transactions within any exclusion other than that stated in § 22(b) (9).

The only provision for the exclusion of these types of gains from the respondent's gross income that is presented for our consideration is the general exemption of gifts from taxation prescribed by § 22(b) (3). This was applied by this Court in favor of a taxpayer in *Helvering* v. *American Dental Co.*, 318 U.S. 322, 63 S. Ct. 577, 87 L. Ed. 785, as well as by the court below in the instant case. Both the general provision for taxation of income and this provision for the exclusion of gifts from gross income, for income tax purposes, have been in the Federal Income Tax Acts in substantially their present form since the Revenue Act of 1916. The contrast between the provisions is striking. The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy. Congress could have excluded from the gross income of all taxpayers the gains derived by debtors either from their acquisitions of their own obligations at a discount and their consequent control over them, or from their respective releases from all or part of such obligations by their respective creditors upon the debtor's payment to the creditor of something less than the full amount of the debt. Congress, especially since the Revenue Act of 1938, has been cognizant of this issue and of its power to meet it as stated, but it has chosen to extend such relief only on the above described restricted and temporary basis and only in the case of corporations. In its treatment of the issue Congress also has required the corporate taxpayer's consent to an alternative plan for a reduction of the corporation's basis of property values to be used in later determinations of its gain or losses. This special treatment is far different from the total exclusion of a gain resulting from an exempt gift. If such gains were already exempted as gifts under § 22(b) (3), as representing something transferred to the debtor for nothing, there would have been no need for § 22(b) (9). The conclusion to be drawn is that such transfers as are described in § 22(b) (9) could not, without more, qualify as exempt gifts under § 22(b) (3). The same may be said of the acquisition, by a natural person, of his own obligations as debtor. The facts in the instant case present a situation quite similar to one contemplated by § 22(b) (9) except that the taxpayer here is a natural person. This emphasizes the taxability of the gains before us.

In the instant case the relation between the bondholder and the respondent may be assumed in each transaction to have been one in which the ultimate parties were known to each other to be such. There was no suggestion in the evidence

or the findings that any bondholder was acting from any interest other than his own. Each transaction was a sale. The seller sought to get as high a price as he could for the bond and the buyer sought to pay as low a price as he could for the same bond. If the transaction had been completely on the open market through a stock exchange, the conduct and intent of each party could have been the same and there would have been little, if any, basis for any claim that the respondent's gain was not taxable income. The mere fact that the seller knew that he was selling to the maker of the bond as his only available market did not change the sale into a gift. In the absence of proof to the contrary, the intent of the seller may be assumed to have been to get all he could for his entire claim. Although the sales price was less than the face of the bond and less than the original issuing price of the bond, there was nothing to indicate that the seller was not getting all that he could for all that he had. There is nothing in the evidence or findings to indicate that he intended to transfer or did transfer something for nothing. The form of the transaction emphasized this relationship. The seller assigned the entire bond to his purchaser. The seller did not first release the maker from a part of the maker's obligation and, having made the maker a gift of that release, then sell him the balance of the bond or vice versa. If the seller actually had intended to give the maker some gift the natural reflection of that gift would have been a credit on the face of the bond or at least some record or testimony evidencing the release. This is not saying that the form of the transaction is conclusive. Assuming that the extension of the maturity of the bonds in the instant case was binding on the creditor, we do not rest this case upon the fact that the sale was made before maturity or that the seller may have received valid consideration for a total release of his claim because the debtor's payment was made before maturity. It is quite possible that a bondholder might make a gift of an entire bond to anyone, including the maker of it. The facts and findings in this case do not establish any such intent of the seller to make a gift in contradiction of the natural implications arising from the sales and assignments which he made. It is conceivable, although hardly likely, that a bondholder, in the ordinary course of business and without any express release of his debtor, might have sold part of his claims on the bonds he held at the full face value of those parts and then have made a gift of the rest of his claims on those bonds to the same debtor "for nothing." It is that kind of extraordinary transaction that the respondent asks us, as a matter of law, to read into the simple sales which actually took place and from which he derived financial gains. We are unable to do so on the findings before us. *Cf. Bogardus* v. *Commissioner of Internal Revenue*, 302 U S. 34, 58 S. Ct. 61, 82 L. Ed. 32.

The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance "for nothing." The latter situation is more likely to arise in connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering* v. *American Dental Co., supra,* than in the sale of outstanding securities, either of a corporation as described in § 22(b) (9), or of a natural person as presented in this case. For these reasons we hold that the Commissioner was justified in finding a taxable gain, rather than an exempt gift, in each of the transactions before us. The judgment of the Court of Appeals accordingly is reversed and the

cause is remanded for further action in accordance with this opinion. It is so ordered.

Reversed and remanded.

MR. JUSTICE RUTLEDGE, although joining in the Court's judgment and opinion, is of the view that the result is essentially in conflict with that reached in *Helvering* v. *American Dental Co.*, 318 U.S. 322, 63 S. Ct. 577, 87 L. Ed. 785.

MR. JUSTICE REED with whom MR. JUSTICE DOUGLAS joins, *dissenting*.

As detailed in *Helvering* v. *American Dental Co.*, 318 U.S. 322, 63 S. Ct. 577, 581, 87 L. Ed. 785, the problems of the tax results to the debtor of the release of indebtedness have been difficult. That opinion shows that both Congress and Internal Revenue Regulations have taken varying views as to whether a taxpayer should pay an income tax on such balance sheet improvements.

We held in the *American Dental* case in 1943 that the "receipt of financial advantages gratuitously" was a gift under Int. Rev. Code § 22, 26 U.S.C.A. § 22. Congress has made no change in the law since that time, nor has it been requested to do so. For the reasons discussed at length in that case, we are of the opinion that the judgment of the Court of Appeals should be affirmed.

Note

1. No doubt if a fond uncle advances to his nephew the expenses of a college education and cancels the debt as a graduation present, the nephew has received not income but a tax-free gift. But the *American Dental Co.* case, which the court distinguishes in the *Jacobson* case, involved a business and its creditors When, in such a context, can a cancellation of indebtedness be a gift? *Marshall Drug Co.* v. *United States*, 95 F. Supp. 820 (Ct. Cl. 1951), cert. den. 341 U.S. 948; *Reynolds* v. *Boos*, 188 F.2d 322 (8th Cir. 1951).

Although any transfer "for less than an adequate and full consideration in money or money's worth" is a gift in the meaning of the gift tax law, I.R.C. § 2512(b), see *Farid-Es-Sultaneh* v. *Commissioner*, *supra*, p. 108, the regulations exclude any transaction in the ordinary course of business "which is bona fide, at arm's length, and free from any donative intent." Reg. 108, Sec. 86.8. In the only reported gift tax case involving a business transaction, the Tax Court said:

> Bad bargains, sales for less than market, sales for less than adequate consideration in money or money's worth are made every day in the business world, for one reason or another, but no one would think for a moment that any gift is involved, even in the broadest possible sense of the term "gift." *Estate of Anderson* v *Commissioner*, 8 T.C 706, 720 (1947).

2. Though not a gift, the cancellation of indebtedness may be exempt from tax on other grounds, as the Court recognizes, in certain special circumstances. When the debt was incurred on the purchase of property, a subsequent settlement for less than the face amount may be held, not always realistically, a downward adjustment of the purchase price. See *Hirsch* v. *Commissioner*, 115 F.2d 656 (7th Cir. 1940). The option which § 108 of the 1954 Code tenders to debtors who settle their obligations for less than face has a similar effect: the debtor's assets must be treated (for the purpose of computing depreciation and gain or loss on a subsequent sale) as though their cost was the cash actually laid out rather than the full purchase price. Another situation in which income is not realized on a cancellation of indebtedness is where the taxpayer was insolvent both before and after the cancellation. *Supra*, p. 69. For special provisions governing the cancellation of debts by a discharge in bankruptcy, see Regs 118, Sec. 39.22(a)-13(b), and §§ 268–270 of the Bankruptcy Act.

3. Is income realized by a debtor when his obligation becomes unenforceable because of the statute of limitations? *Securities Co.* v. *United States*, 85 F. Supp. 532 (S.D.N.Y. 1948).

4. See generally Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 *Yale L.J* 1153 (1940), Note, 16 *U. of Chi. L. Rev.* 725 (1949); Wright, "Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness I and II," 49 *Mich. L. Rev.* 459, 667 (1951).

ROBERTSON v. UNITED STATES

Supreme Court of the U.S, 1952
343 U.S. 711

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

Petitioner is a musician and composer who between the years 1936 and 1939 composed a symphony. In 1945 Henry H. Reichhold, a philanthropist, established a music award offering $25,000, $5,000, and $2,500 for the three best symphonic works written by native-born composers of this hemisphere. The terms of the offer provided that none of the compositions could be published or publicly performed prior to entry in the contest and that each composition receiving an award would remain the property of the composer except that he would grant the Detroit Orchestra, Inc., (1) all synchronization rights as applied to motion pictures, (2) all mechanical rights as applied to phonograph recordings, electrical transcriptions and music rolls, and (3) the exclusive right to authorize the first performance of the composition in each of the countries whose citizens were eligible to enter the contest and to designate the publisher of the composition.

Petitioner submitted his symphony and on December 14, 1947, won the $25,000 award. He included that amount in his 1947 income tax return as gross income. . . . Thereafter he filed a claim for refund on the ground that the award constituted a nontaxable gift.[1] . . . The District Court, 93 F. Supp. 660, held that the award was a gift and not taxable by reason of § 22(b) (3) of the Internal Revenue Code, 26 U.S.C.A. § 22(b) (3). The Court of Appeals reversed. 190 F.2d 680. The case is here on certiorari because of the conflict between that decision and *McDermott* v. *Commissioner*, 80 U.S. App. D.C. 176, 150 F.2d 585, decided by the Court of Appeals for the District of Columbia. And see *Williams* v. *United States*, 84 F. Supp. 362, 114 Ct. Cl. 1.

I.

In the legal sense payment of a prize to a winner of a contest is the discharge of a contractual obligation. The acceptance by the contestants of the offer tendered by the sponsor of the contest creates an enforceable contract. See 6 *Corbin on Contracts* § 1489, *Restatement*, *Contracts*, § 521. The discharge of legal obligations—the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift. The case would be different if an award were made in recognition of past achievements or present abilities, or if payment was given not for services, see *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 730, 49 S. Ct. 499, 504, 73 L. Ed. 918, but out of affection, respect, admiration, charity or like impulses. Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it. . . .

[1] Section 22(b) (3) of the Internal Revenue Code provides.
"The following items shall not be included in gross income and shall be exempt from taxation under this chapter: . . .
"The value of property acquired by gift, bequest, devise, or inheritance. . . ."

Affirmed.

MR. JUSTICE FRANKFURTER, not having heard the argument owing to illness, took no part in the disposition of this case.

MR. JUSTICE JACKSON dissents.

Note

1. See § 74 of the 1954 Code, which is patterned largely on the language of the *Robertson* case. The *McDermott* case, cited in and presumably overruled in principle by the *Robertson* case, held that a prize awarded by the American Bar Association for the best essay on a stipulated subject of scholarly interest was not taxable. One of the grounds of decision was that the Association derived no commercial benefit from the contest. Note the last sentence in the extract from the *Robertson* case, and see § 74(b)(1). In *Washburn* v. *Commissioner*, 5 T.C. 1335 (1945) decided before the *Robertson* case, it was held that a "Pot O' Gold" prize, awarded to a radio listener for being at home when the telephone rang, was not taxable, the committee reports on the 1954 Code state specifically that this decision is overruled. H. Rept p. 11, S. Rept. p. 178. After the *Robertson* case was decided, it was held in *Bates* v. *Glenn*, 114 F. Supp. 445 (W.D. Ky. 1953), that an automobile awarded as a door prize to the taxpayer after a visit to a dealer's showroom was a "gift," the *Robertson* case being distinguished because there the taxpayer had entered a contest. Although not mentioned in the committee reports, presumably this case is also overruled.

If an admiring friend enters a girl's name in a beauty or popularity contest, is the prize taxable?

2. What is the amount of taxable income if the prize is a trip to Miami, a life-time supply of fig newtons, or something else that the winner would not have purchased with his own money? See *Turner* v. *Commissioner*, ¶ 54,142 P-H Memo TC. What if the winner sells the award at a fraction of its retail value, or refuses it altogether? See McNulty, "The Jackpot," *New Yorker* (February 19, 1949).

3. Section 117 of the 1954 Code establishes statutory standards for the taxability of scholarships and fellowships. Previously, the only applicable statutory provision was § 22(b)(3) of the 1939 Code, exempting gifts. While it was generally assumed that virtually all scholarships and many fellowships were excluded from gross income, some awards of this type entailed the performance of services or at least the completion of a research project, and hence there was a possibility that the award would be taxable compensation, rather than a gift. For example, in *Banks* v. *Commissioner*, 17 T.C. 1386 (1952), a research fellowship awarded to a candidate for a Ph. D. degree was held to be taxable compensation; the taxpayer was required to work 35 hours per week, under the direction of a member of the faculty, on a project prescribed by the institution. His work was, however, submitted in partial satisfaction of the requirements for the doctorate. The payments were treated as salary on the books of the institution, and in practice, fellowships were probably ordinarily treated as taxable income or as gifts by the recipients according to whether or not the institution withheld income tax from the payments. See also *Loo* v. *Commissioner*, 22 T.C No 30 (1954). More controversial than the *Banks* case was the policy announced by the Internal Revenue Service in I.T. 4056, 1951-2 C.B. 8, involving a number of fellowship awards, apparently by the Guggenheim Foundation:

> If a grant or fellowship award is made for the training and education of an individual, either as a part of his program in acquiring a degree or in otherwise furthering his educational development, no services being rendered as consideration therefor, the amount of the grant or award is a gift which is excludable from gross income. However, when the recipient of a grant or fellowship applies his skill and training to advance research, creative work, or some other project or activity, the essential elements of a gift as contemplated by Section 22(b)(3) of the Internal Revenue Code are not present, and the amount of the grant or fellowship is includible in the recipient's gross income.

4. How is all this affected by § 117? If the taxpayer in the *Banks* case, after receiving his doctorate, had continued to work on the same project under the same terms, would he come within § 117(b)(2)? Would a non-teaching member of a university faculty qualify for the exclusion of § 117(b)(2), if the university labels his regular stipend as a "fellowship" rather than "salary?" Could a university employ its professors to teach for half their regular salaries and pay the rest to them as research fellowships? Is it possible for the Ford Foundation to make a "gift" to a scholar that will be totally exempt under § 102 instead of partially exempt under § 117? Can a business corporation or a private individual, whose grants would not qualify under § 117(b)(2)(A), make a gift to a scientist under § 102 to finance his research?

2. *Bequests*

Note: Section 22(b)(3) of the 1939 Code, which is carried over without substantive change as § 102 of the 1954 Code, was encountered in the previous section. It excludes from gross income property acquired by bequest, inheritance, and devise, as well as property acquired by gift.

Section 113(a)(5) of the 1939 Code provided that the basis to the recipient of property acquired by bequest, inheritance, or devise was its fair market value at the date of the decedent's death (or, if the decedent's estate was valued for federal estate tax purposes as of one year after death, in accordance with the privilege accorded by § 811(j) of the 1939 Code, now § 2032 of the 1954 Code, its value as of that time). Section 1014 of the 1954 Code carries over this principle, somewhat extended to embrace certain items of property that may not have been received by bequest, inheritance, or devise but that were nevertheless includible in the decedent's estate under the federal estate tax law. See S. Rept. pp. 423-424.

See Regs. 118, Secs. 39.22(b)(3)-1 and 39 113(a)(5)-1(b)(1).

LYETH v. HOEY

Supreme Court of the U. S., 1938
305 U S. 188

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

The question presented is whether property received by petitioner from the estate of a decedent in compromise of his claim as an heir is taxable as income under the Revenue Act of 1932, 47 Stat. 173.

Petitioner is a grandson of Mary B. Longyear who died in 1931, a resident of Massachusetts, leaving as her heirs four surviving children and the petitioner and his brother, who were sons of a deceased daughter. By her will, the decedent gave to her heirs certain small legacies and the entire residuary estate, amounting to more than $3,000,000, was bequeathed to trustees of a so-called Endowment Trust, created April 5, 1926, the income from which was payable to another set of trustees under another trust described as the Longyear Foundation. The main purpose of the latter trust was to preserve "the records of the earthly life of Mary Baker Eddy," the founder of the Christian Science religion.

When the will was offered for probate in Massachusetts there was objection by the heirs upon the grounds, among others, of lack of testamentary capacity and undue influence. After hearing, at which a statement was made by the respective

parties of their proposed evidence, the probate court granted a motion for the framing of issues for trial before a jury. In that situation a compromise agreement was entered into between the heirs, the legatees, the devisees and the executors under the will and the Attorney General of Massachusetts. This agreement provided that the will should be admitted to probate and letters testamentary issued, that the specific and pecuniary bequests to individuals should be enforced; that the bequest of the residuary estate to the Endowment Trust should be disregarded; that $200,000 should be paid to the heirs and a like amount to the Endowment Trust, and that the net residue of the estate, as defined, should be equally divided between the trustees of the Endowment Trust and the heirs. . . . The Commissioner of Internal Revenue valued [petitioner's] distributable share at $141,484.03 and treated the whole amount as income for the year 1933 in which it was received. An additional tax of $56,389.65 was assessed which petitioner paid in October, 1936, with interest. Claim for refund was then filed and on its rejection this suit was brought against the collector.

On motion of petitioner the District Court entered a summary judgment in his favor (20 F. Supp. 619) which the Circuit Court of Appeals reversed. 2 Cir., 96 F.2d 141. Because of a conflict with the decision of the Circuit Court of Appeals of the Fourth Circuit in *Magruder* v. *Segebade*, 94 F.2d 177, certiorari was granted, May 31, 1938, 304 U.S. 557, 58 S.Ct. 1060, 82 L. Ed. 1525.

The Court of Appeals overruled the contentions of petitioner that the property he received was within the statutory exemption (Section 22(b) (3) of the Revenue Act of 1932, 26 U.S.C.A. § 22(b) (3)), and, further, that the property was not income either under the statute or under the Sixteenth Amendment of the Federal Constitution. As the view of the Court of Appeals upon these questions determined the rights of the parties, it was found unnecessary to discuss certain affirmative defenses set up by the answer of the respondent and these defenses are not pressed in this court.

First.—By section 22(b) (3) of the Revenue Act of 1932, 26 U.S.C.A. § 22(b) (3), there is exempted from the income tax—

"The value of property acquired by gift, bequest, devise, or inheritance. . . ."

Whether property received by an heir from the estate of his ancestor is acquired by inheritance, when it is distributed under an agreement settling a contest by the heir of the validity of the decedent's will, is a question upon which state courts have differed. The question has arisen in the application of state laws of taxation. In Massachusetts, the rule is that when a will is admitted to probate under a compromise agreement, the state succession tax is applied to the property "that passes by the terms of the will as written and not as changed by any agreement for compromise." *Baxter* v. *Treasurer & Receiver General*, 209 Mass. 459, 463, 95 N.E. 854, 856. Although under the Massachusetts statute relating to compromise it is the practice to insert a clause in the court's decree that the estate is to be administered in accordance with the agreement, "yet the rights of the parties so far as they rest upon the agreement are contractual and not testamentary." *Ellis* v. *Hunt*, 228 Mass. 39, 43, 116 N.E. 956. See, also, *Brandeis* v. *Atkins*, 204 Mass. 471, 474, 90 N.E. 861, 26 L.R.A.,N.S., 230; *Copeland* v. *Wheelwright*, 230 Mass. 131, 136, 119 N.E. 667. Thus, when a contest was withdrawn under a compromise and the residuary estate was divided equally between the legatee and the

heirs, it was held that the tax was properly levied upon the entire residuary legacy and that the administrators with the will annexed had no right to pay out of the share transferred to the heirs one-half of the tax thus collectible from the legatee unless the compromise agreement expressly or impliedly so provided. *Brown* v. *McLoughlin*, 287 Mass. 15, 17, 190 N.E. 795. Several States have a similar rule. In other States the amount received by an heir under an agreement compromising a contest of his ancestor's will is considered to be received by virtue of his heirship and is subject to an inheritance tax unless the statute exempts him.

In the instant case, the Court of Appeals applied the Massachusetts rule, holding that whether the property was received by way of inheritance depended "upon the law of the jurisdiction under which this taxpayer received it" [page 143]. We think that this ruling was erroneous. The question as to the construction of the exemption in the federal statute is not determined by local law. We are not concerned with the peculiarities and special incidences of state taxes or with the policies they reflect. Undoubtedly the state law determines what persons are qualified to inherit property within the jurisdiction. *Mager* v. *Grima*, 8 How. 490, 493, 12 L. Ed. 1168, *Maxwell* v. *Bugbee*, 250 U.S. 525, 536, 537, 40 S. Ct. 2, 5, 63 L. Ed. 1124. The local law determines the right to make a testamentary disposition of such property and the conditions essential to the validity of wills, and the state courts settle their construction. *Uterhart* v. *United States*, 240 U.S. 598, 603, 36 S. Ct. 417, 418, 60 L. Ed. 819. The State establishes the procedure governing the probate of wills and the processes of administration. Petitioner's status as heir was thus determined by the law of Massachusetts. That law also regulated the procedure by which his rights as an heir could be vindicated. The state law authorized its courts to supervise the making of agreements compromising contests by heirs of the validity of an alleged will of their ancestor, in order that such compromises shall be just and reasonable with respect to all persons in interest. But when the contestant is an heir and a valid compromise agreement has been made and there is a distribution to the heir from the decedent's estate accordingly, the question whether what the heir has thus received has been "acquired by inheritance" within the meaning of the federal statute necessarily is a federal question. It is not determined by local characterization.

In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted "so as to give a uniform application to a nation-wide scheme of taxation." *Burnet* v. *Harmel*, 287 U.S. 103, 110, 53 S. Ct. 74, 77, 77 L. Ed. 199. Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. *Burnet* v. *Harmel*, *supra*. . . . There is no such expression or necessary implication in this instance. Whether what an heir receives from the estate of his ancestor through the compromise of his contest of his ancestor's will should be regarded as within the exemption from the federal tax should not be decided in one way in the case of an heir in Pennsylvania or Minnesota and in another way in the case of an heir in Massachusetts or New York, according to the differing views of the state courts. We think that it was the intention of Congress in establishing this exemption to provide a uniform rule.

Second.—In exempting from the income tax the value of property acquired by "bequest, devise, or inheritance," Congress used comprehensive terms embracing all acquisitions in the devolution of a decedent's estate. For the word "descent," as used in the earlier acts, Congress substituted the word "inheritance" in the 1926 act and the subsequent revenue acts as "more appropriately including both real and personal property." Thus the acquisition by succession to a decedent's estate whether real or personal was embraced in the exemption. Further, by the "estate tax," Congress has imposed a tax upon the transfer of the entire net estate of every person dying after September 8, 1916, allowing such exemptions as it sees fit in arriving at the net estate. Congress has not indicated any intention to tax again the value of the property which legatees, devisees or heirs receive from the decedent's estate.

Petitioner was concededly an heir of his grandmother under the Massachusetts statute. It was by virtue of that heirship that he opposed probate of her alleged will which constituted an obstacle to the enforcement of his right. Save as heir he had no standing. Seeking to remove that obstacle, he asserted that the will was invalid because of want of testamentary capacity and undue influence. In accordance with local practice, he asked the probate court to frame these issues for a jury trial. It then became necessary for him to satisfy the court that the issues were substantial. Issues are not to be framed unless it appears from statements by counsel or expected evidence or otherwise that there is a "genuine question of fact supported by evidence of such substantial nature as to afford ground for reasonable expectation of a result favorable to the party requesting the framing of issues." *Briggs* v. *Weston*, Mass., 2 N.E.2d 466, 467; *Smith* v. *Patterson*, 286 Mass. 356, 190 N.E. 536. Petitioner satisfied that condition and the probate court directed the framing of jury issues. It was in that situation, facing a trial of the issue of the validity of the will, that the compromise was made by which the heirs, including the petitioner, were to receive certain portions of the decedent's estate.

There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption. It does so, because it disregards the heirship which underlay the compromise, the status which commanded that agreement and was recognized by it. While the will was admitted to probate, the decree also required the distribution of the estate in accordance with the compromise and, so far as the latter provided for distribution to the heirs, it overrode the will. So far as the will became effective under the agreement it was because of the heirs' consent and release and in consideration of the distribution they received by reason of their being heirs. Respondent agrees that the word "inheritance" as used in the federal statute is not solely applicable to cases of complete intestacy. The portion of the decedent's property which petitioner obtained under the compromise did

not come to him through the testator's will. That portion he obtained because of his heirship and to that extent he took in spite of the will and as in case of intestacy. The fact that petitioner received less than the amount of his claim did not alter its nature or the quality of its recognition through the distribution which he did receive.

We are not convinced by the argument that petitioner had but "the expectations" of an heir and realized on a "bargaining position." He was heir in fact. Whether he would receive any property in that capacity depended upon the validity of his ancestor's will and the extent to which it would dispose of his ancestor's estate. When, by compromise and the decree enforcing it, that disposition was limited, what he got from the estate came to him because he was heir, the compromise serving to remove pro tanto the impediment to his inheritance We are of the opinion that the exemption applies.

In this view we find it unnecessary to consider the other questions that have been discussed at the bar.

The judgment of the Circuit Court of Appeals is reversed and that of the District Court is affirmed.

Note

1 Note the Court's statement that the taxpayer "was heir in fact" If that status were in dispute, would a payment in compromise of his claim be tax-free? In *United States* v. *Gavin*, 159 F.2d 613 (9th Cir 1947), a payment to one claiming as an illegitimate child of the deceased was held tax-free, though as part of the compromise the claimant agreed to refrain from asserting her paternity in the future and consented to a probate decree finding against the relationship.

2. When a testator names a relative or friend as executor, it is common to provide for a "bequest" in lieu of the statutory commissions to which the executor would be entitled for his services. The Supreme Court has held that if mere qualification as executor (as distinguished from the performance of services) is sufficient to entitle the individual to the payment, it constitutes a bequest rather than taxable compensation. *United States* v. *Merriam*, 263 U S 179(1923). See *Bank of New York* v. *Helvering*, 132 F.2d 773 (2d Cir. 1943), illustrating the difficulty courts have encountered in applying the Supreme Court's distinction. Query why should the testator have required the individual to qualify as executor to be eligible for the bequest? Would one really be entitled to the bequest if he qualified and promptly resigned without cause? In the *Bank of New York* case, the amount granted to the executor by the will exceeded the statutory commissions, and the executor (or rather *his* executors, since in the meantime he had died) treated only the excess as a bequest. Was this too generous to the government?

HATCH v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1951
190 F.2d 254

Before Swan, Chase and Frank, Circuit Judges

Swan, Circuit Judge.

The petitioner is the widow and sole legatee of Frederic H. Hatch, who died April 2, 1930. Among the decedent's assets was a contract, dated May 19, 1928, by the terms of which Frederic H. Hatch & Co., a corporation, agreed to employ him for ten years at an annual salary of $30,000 and, in the event of his death,

agreed to pay the annual salary to his estate for ten years beginning on the date of death. The corporation also assumed an obligation contingent on the amount of the corporation's net earnings to pay his estate an additional sum, but no payment was ever made under this provision of the contract. For purposes of the federal estate tax the contract was valued at $243,326.70.[1] By mutual consent of Mrs. Hatch and the corporation the annual salary payments were varied from time to time and less than $30,000 per year was paid, but, as of December 31, 1941, in which year she was paid $15,750, the total payments received by her exceeded the estate tax valuation of the contract by $7,923.30, and in each of the years 1942 and 1943 she received $12,000. The excess payments were not returned by her as income. The Commissioner ruled that they should have been and determined deficiency assessments which the Tax Court has sustained, with two members dissenting. 14 T.C. 237.

On this appeal the taxpayer makes three contentions· (1) that the payments in excess of the commuted value of her husband's employment contract are not taxable income to his legatee; (2) that if the difference between the face amount of the contract and its estate tax valuation is income, such income should be allocated over the life of the contract with the result that each of the payments represents part income and part return of capital; and (3) that assessment of a deficiency for the year 1941 was barred by section 275(a) of the Internal Revenue Code, 26 U.S.C.A. § 275(a).

Section 22(a) of the Code provides that gross income shall include "gains . . . derived from any source whatever . . .", but section 22(b) (3) excludes from gross income and exempts from federal income taxation "The value of property acquired by gift, bequest, devise, or inheritance." Section 111(a) provides that "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain. . . ." The adjusted basis provided by section 113(b) is the unadjusted basis of section 113(a) less items properly chargeable to capital account. And section 113(a) (5) deals with property transmitted at death and provides: "If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition."

Any doubt that the amounts received by Mrs. Hatch in excess of the estate tax valuation of the contract are taxable income is dispelled for this court by our decision in *Helvering* v. *Roth*, 2 Cir., 115 F.2d 239. We there held that amounts received in payment of notes valued as worthless in the estate of the recipient's testator were income to the recipient. The *Roth* case is not distinguishable, as the petitioner suggests, on the ground that payments by the corporation on her claim did not constitute a "disposition" of the claim within section 111(a), as did retirement of the Roth notes. We agree with Judge Goodrich that receipt of an amount due on a contract obligation is *pro tanto* a "disposition"—relinquishment—of the obligation.[2] But even were we to assume *arguendo*, that there were no "disposition" within section 111(a), we think it clear that payments in excess of the

[1] This was computed on the basis of the present value factor of $30,000 a year for a 10 year term-certain, in accordance with the factor which now appears in Table B of Regulations 105 No value was ascribed to the obligation contingent on the corporation's net earnings.

[2] Herbert's Estate v. Commissioner, 3 Cir., 139 F.2d 756, 758, certiorari denied 322 U.S. 753, 64 S. Ct. 1263, 88 L. Ed. 1282. See also United States v. Archer, 1 Cir., 174 F.2d 353, 356.

estate tax valuation of the contract constituted taxable income within the broad definition of section 22(a), which includes any gain not specifically excluded by other provisions of the Code. Section 22(b) (3) excludes from section 22(a) the "value" of property acquired by bequest. How property acquired by bequest is to be valued is provided by section 113(a)(5) which declares that the basis for determining gain or loss, in the case of a bequest "shall be the fair market value of such property at the time of . . . acquisition." Hence the "value" of the bequest excluded from taxation by section 22(b) (3) was $243,326.70, and anything received in excess of such value is taxable "gain" within section 22(a), as stated in the *Roth* case, 115 F.2d 239, 241. Although this conclusion appears to be contrary to that reached in *United States* v. *Carter*, 5 Cir., 19 F.2d 121, we adhere to what was said of that case in the *Roth* opinion.

We pass now to the petitioner's alternative contention, namely, that the difference between the face amount of the contract and its estate tax valuation should be allocated over the life of the contract. The Tax Court rejected this contention and held that the excess payments were 100% income. With this conclusion we are unable to agree. When Mrs. Hatch acquired the contract under her husband's will, it was obviously worth less than $300,000, the total salary payments called for by its terms, since a promisor's obligation to pay $30,000 a year for ten years is not the equivalent of an obligation to pay $300,000 forthwith. The present value of the contract was computed by discounting the future payments in accordance with the factor which now appears in Table B of Regulations 105. When the obligation shall have been discharged in full Mrs Hatch will have received a return of the acquisition value of the contract, $243,326.70 plus the discount of $56,673.30 by which the face amount of the contract was reduced. The former amount is excludible from taxation as the "value" of property acquired by bequest, the latter is taxable as "gain." When the obligation is discharged in periodic payments, "It is no more correct to say that the part payment was all a return of principal than it is to say it was all a return of income." [3] We think that each installment payment received by Mrs. Hatch should be allocated between the non-taxable bequest and the taxable gain. According to Table B, used to obtain the present worth of the contract, 81.1089 per cent. of each payment represents present worth and 18.8911 per cent. represents gain. Hence the taxpayer contends that only 18.8911 per cent. of the payments received during the years here involved is taxable. This would mean $2,975.35 for 1941 and $2,266.93 for each of the years 1942 and 1943.

The Commissioner does not contend that statutory authority is essential to the use of the allocation method in a case where the amount of future gain is definitely determinable. He denies, however, that the amount of future gain is definitely determinable in the case at bar, relying upon *Burnet* v. *Logan*, 283 U.S. 404, 51 S. Ct. 550, 75 L. Ed. 1143. We find nothing in that case to render inapplicable the views we have expressed. It was there held that the allocation method may not be applied to a contract in which the ultimate amount to be received thereunder could not be determined with reasonable certainty because the promise of the obligor was conditional on the amount of iron which it might mine. By contrast, the contract in the case at bar obligated the corporation to pay a fixed sum yearly for a ten year term, so that its present value was neither speculative nor difficult to estimate. It is true that the contract also contained a contingent obligation which

[3] The quotation is from Shafpa Realty Corp. v Commissioner, 8 B.T A. 283, 284, see also Gilbert v Commissioner, 6 T.C. 10, 13; Platt v. Bowers, D C N.Y., 13 F 2d 951, 952.

might have increased the amount to be paid by $100,000, but no value was ascribed to this contingent promise in fixing the estate tax valuation. Nor can it be inferred, as the Commissioner suggests, that the fact that the annual sums payable were varied from time to time by mutual consent indicates that the financial condition of the corporation was such as to create doubt whether the contract would be completely carried out. So far as appears the modifications agreed upon may have been made at the taxpayer's request and for her convenience. The estate tax valuation presupposed complete performance of the obligation to make the salary payments.

If as we hold, the amounts received annually should be allocated between income and return of capital—value of the bequest at date of acquisition—the Commissioner's assessment of a deficiency for the year 1941 was barred by the three year statute of limitation, section 275(a)* of the Code, unless the period was extended by section 275(c),† which provides a five year limitation if the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per cent. of the gross income stated in the return. The Commissioner has made no argument that, if the allocation method is applicable, the 1941 assessment was timely. Applying the principle enunciated in *Green* v. *Commissioner*,[4] with which we are in accord, it appears that the amount of gross income omitted from the return was not sufficient to bring into play the five year limitation of section 275(c).

For the foregoing reasons we hold that the 1941 deficiency should be expunged and the 1943 deficiency be recomputed. Decision reversed and cause remanded for further proceedings in conformity with this opinion.

Note

1. Assume that the contract had been valued at zero for estate tax purposes because of the employer's uncertain financial circumstances, because payments were contingent on insecure profits, or for some other sufficient reason. Does § 102 exclude from income only the "value" of the property at the decedent's death? Does § 1014 require this result? If so, *A* and *B*, both widows, may be treated differently with respect to identical receipts, if their contracts were valued differently: *A* pays little or no income tax, because her husband worked for a prosperous firm, *B* pays more because her payments are more precarious. The difference in income tax is not necessarily a reflection of a higher estate tax on *A*'s inheritance; both estates may have been non-taxable because of exemptions, debts, or other offsets

2. Section 102(b)(2) as it now stands codifies the holding in *Irwin* v *Gavit*, 268 U S. 161 (1925), with respect to the income beneficiary of a trust fund. There it was held that the beneficiary must report the income distributed to him, he was not allowed to exclude it on the theory that he had been given or had inherited a series of payments

3. Life Insurance

***Note:* Section 22(b)(1) of the 1939 Code excluded from gross income amounts received under a life insurance contract, paid by reason of the death of the insured. This general principle has been carried forward by §§ 101(a), 101(c), and 101(d) of the 1954**

* Section 6501(a) of the 1954 Code.

† Section 6501(e) is similar to but not identical with § 275(c) of the 1939 Code. [Ed.]

[4] 7 T.C. 263, affirmed 6 Cir., 168 F.2d 994. [Ed.]

Code, but important changes have been made in the treatment of interest paid by the insurance company where the proceeds of the policy are not paid in a lump sum.

The old statute continues to be applicable to amounts received under a life insurance contract if the insured died before the 1954 Code was enacted.

COMMISSIONER v. PIERCE

U S. Court of Appeals, Second Circuit, 1944
146 F.2d 388

Before L. HAND, AUGUSTUS N. HAND, and FRANK, Circuit Judges.

L. HAND, Circuit Judge.

Both the Commissioner and the taxpayer appeal from an order of the Tax Court, which expunged in part, and affirmed in part, a deficiency assessment for income taxes against the taxpayer for the year 1940. (The taxpayer has not pressed her appeal before us, and we understand it to be abandoned.) The taxpayer's husband died on March 18, 1940, leaving a life insurance policy in the sum of $100,000, in which he had named her as the beneficiary. The policy first contained an unconditional promise to pay to the taxpayer on the death of her husband, "the sum of $100,000," and later provided as follows

> The Insured shall have the right with the privilege of revocation and change, to elect in lieu of payment in one sum either Option "A," "B" or "C," or that the amount payable be distributed under two or more of said Options. The Beneficiary . . when this Policy becomes payable, shall have the same right and privilege if no such election effected by the Insured shall then be in force

The taxpayer's husband did not during his life elect any of the options, but after his death, in accordance with the language just quoted, the taxpayer elected to take under "Option 'C'," which gave her the right to have the net proceeds of the policy paid

> In either 10, 15, 20 or 25 stipulated installments of an amount corresponding in the Table below to the age of the Beneficiary at the death of the Insured, provided that if the Beneficiary shall survive to receive the number of installments selected, similar installments shall be continued during the lifetime of the Beneficiary

She chose to be paid in ten installments: *i.e.*, 120 monthly installments spread over 10 years. At her age each payment came to $597, and they were to continue as long as she lived. To these installments the insurer added such monthly dividends as were declared upon the policy—these being the subject of the taxpayer's appeal. For the year 1940 she received ten installments, aggregating $6,294, together with nine monthly dividends for $36 each. She did not return any of these as income, relying upon § 22(b)(1) of the Internal Revenue Code, 26 U.S.C.A. Int. Rev. Code, § 22(b)(1), which excludes from gross income and exempts from taxes the following:

> Life insurance Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income).

The Commissioner assessed a deficiency against her of $2,009.51, which he computed as follows. He divided the principal of the policy—$100,000—by the figure 19.45—that being the taxpayer's expectancy in 1940—this gave a quotient of $5,141.39, of which he took five-sixths—there being only ten monthly payments in the year 1940. The result was $4,284.49, and this he treated as the proper amortization payment of the capital sum of $100,000, the difference—$6,294 minus $4,284 49—he treated as income and taxed accordingly. Upon review by all the judges of the Tax Court, it was held, two judges dissenting, that the taxpayer was right; the deficiency was expunged, except as to the nine dividends already mentioned; and from this order the Commissioner appealed.

Four Circuit Courts of Appeals have held that § 22(b)(1) does not mean to separate such installments as are here in question into principal and interest and to include the interest in gross income; but that it exempts the whole installment. *Commissioner* v. *Winslow*, 1 Cir., 113 F.2d 418, 133 A.L.R. 405; *Commissioner* v. *Bartlett*, 2 Cir., 113 F.2d 766, *Commissioner* v. *Buck*, 2 Cir., 120 F.2d 775; *Allis* v. *La Budde*, 7 Cir., 128 F.2d 838; *Kaufman* v. *United States*, 4 Cir., 131 F.2d 854. The parenthesis applies to cases where the capital sum is retained for a season undiminished, and only the interest is paid to the beneficiary (*United States* v. *Heilbroner*, 2 Cir., 100 F.2d 379); and in economic theory there is no difference between such interest, and the interest concealed in an installment, for, when an insurer pays the beneficiary in a series of installments, it always does add something as interest upon those installments which for the time being it retains. Nevertheless, although for this reason the distinction is to some extent formal, the courts have thought that they saw adequate ground for it in the language used, and the Commissioner, after many unsuccessful efforts, has finally yielded and amended his regulations accordingly (Regulations 118, § 39.22(b)(1)-1). We are, therefore to take it as datum that, if the insured had during his life elected to take under "Option 'C'," the Tax Court would have been right. The Commissioner insists, however, that his earlier position is still valid when, as here, it was the beneficiary, not the insured, who made the choice. The argument is that, since she had the option of choosing between the principal and one of the options, it is as though she had actually received the principal and had reinvested it with the insurer, instead of upon some other security Were that done, the resulting payments would have to be broken down into earnings and amortization installments, and, qua earnings, would be taxable.

It cannot be seriously argued that, literally at any rate, the installments are not "paid by reason of the death of the insured"; they are all conditional upon that event, and they begin to be payable at once thereafter. Pro tanto, they are precisely like any other life insurance, all of which is payable "by reason of the death of the insured." We recognize, however, that that is not a final answer; for, granting that the insured's death is a condition precedent, it is not the only condition precedent to the payments in question, as it is when the insured himself makes the choice. If the words should be read. "only by reason of the death of the insured," the meaning would be as the Commissioner maintains; and our decision turns upon whether that is their right interpretation.

The policy offered the beneficiary a choice between rights already in existence, with whose creations she had had nothing whatever to do, they came to her ready made by the insured. To say that her position was the same as though, having the

principal in hand, she had exchanged it with the insurer for the option, is untrue in fact and unwarranted in law. Perhaps, if the policy had not contained the options, the beneficiary might still have been able to buy "Option 'C' " from the insurer by a direct bargain; but nothing in the record supports that assumption, and we have no right to make it. Life insurance is a technical subject, and it would be hazardous to say that it made no difference in the beneficiary's powers in dealing with the insurer that the policy contained the options. But even if it did make no difference, it is a fiction to treat the situation as though she had made such a bargain; it is as untrue as it would be to say that if the policy permitted her to be paid in dollars or pounds, and she took pounds, she had bought the pounds from the insurer with the dollars. It is as untrue as it would be to say that, if a testator gives a legatee the choice of money or a chattel and he takes the chattel, he has bought it of the executor. In such situations the beneficiary makes no bargain whatever with the decedent's representative; all that happens is that, not having the power to take both benefits, and being therefore put to a choice, he takes one of those already provided. Nothing will justify the violence to the language necessary to the Commissioner's interpretation, unless it is necessary to effectuate the underlying purpose of the statute. In this instance it would defeat that purpose.

We are to assume that Congress wished to favor the class of dependents in whose behalf life insurance is ordinarily secured—the wife and children of the insured. Although that involves an exemption from taxation and exemptions are viewed with jealousy, when the purpose is evident enough, we should not defeat or mutilate its realization. The proposed distinction does not rest upon any difference in the class who will profit by the exemption, it does not rest upon any difference in the kind of property exempted, it does not rest upon any language in the statute—on the contrary it demands that we import a word which is not there: "only." Moreover, it would make a difference which in practice would impair the underlying purpose. If the Commissioner is right, an insured who has taken out such a policy, and who wishes to give the beneficiary—ordinarily his wife—the power to decide how she will use the proceeds, must consult her in advance, and act while he lives, unless he is willing to forego the exemption. As he cannot tell when he will die, he must make sure that he keeps abreast of all changes in their financial position, and provides for them; he will be unable to give her the power after his death to adapt her means to her needs. True, that extention will be short, she cannot wait long before electing; but at least she has some time within which to act, and this may be extremely important in those cases—which are apt to be frequent—in which through inattention, or through the assumption, common to us all, that death is not at hand, the insured has failed to do what the new situation demanded. For these reasons, as we have said, to import the necessary word would positively defeat the purpose of Congress

In conclusion, we think that there are one or two analogies, which, while by no means on all fours, nevertheless look in the same direction. When a widow accepts her husband's testamentary provision in lieu of dower, she is held to take under the will, though it is only by performing the condition—releasing the dower—that she can take. *Helvering* v. *Butterworth*, 290 U.S. 365, 54 S. Ct. 221, 78 L. Ed. 365. Again, when an heir who contests a will, the contest remaining undecided, settles with the executor, he takes by inheritance, though it is again only by conforming to a condition that he gets his share *Lyeth* v. *Hoey*, 305 U.S. 188,

59 S. Ct. 155, 83 L. Ed. 119, 119 A.L.R. 410. These decisions do not of course declare that the widow, or the heir, takes "only" from the husband or the ancestor, yet they are instances in which we do think of the property as passing only "by reason of" death, although some concurring act of the transferee is necessary. And indeed it is always true of any devise, and of any legacy, that the devisee or the legatee must accept it in order to pass the property. Acceptance is a condition not always fulfilled—as for example, when the testator has attached obligations to it—; yet we should suppose that nobody would hesitate to say of such a devise or legacy that it passed "by reason of the death" of the testator.

Order affirmed.

FRANK, Circuit Judge (*dissenting*).

We are dealing here with an exemption statute. It is hornbook law that such statutes are to be construed against the person claiming the exemption, and that for a good reason: Every exemption increases the tax burden of other taxpayers, and it is not lightly to be assumed that Congress intended inequality of tax burdens. I think my colleagues, with no support from any legislative history, have here ignored that doctrine. The statute exempts "amounts received under a life insurance contract paid by reason of the death of the insured." Are the amounts here paid "by reason of" such death? Yes, in part, for the contract made by the insured provided that the beneficiary upon the death of the insured should have an option, so that the option came into being "by reason of" his death. But the death alone did not bring about such payment, it required both (a) the death of the insured and (b) the election, after that death, of the beneficiary to exercise the option. The question, then, is this: Did Congress mean (1) "paid in part by reason of the death" or (2) "paid solely by reason of the death"? Because of the doctrine as to tax exemptions, it seems to me that we should hold that Congress meant the latter, *i.e.*, "solely."

Having in mind that, concededly, the amount received by taxpayer was not paid to her solely by reason of the death of the insured, I am persuaded by the reasoning in the dissenting opinion of Chief Judge Lehman in *Latterman* v. *Guardian Life Insurance Company*, 280 N.Y. 102, 106-108, 19 N.E.2d 978, 127 A.L.R. 450. Doubtless the death of the insured conferred on the taxpayer, because of the insurance contract, a privilege to make an investment which, but for the death, would probably not have been available to her. But the money is paid by the insurance company not "by reason of the death," but because the beneficiary exercised a deliberate choice to avail herself of the privilege of making such an investment.

I think my colleagues are well advised in stating that the two decisions which they suggest as analogies are "by no means on all fours." In *Helvering* v. *Butterworth*, 290 U.S. 365, 54 S. Ct. 221, 78 L. Ed. 365, the taxpayer was defeated; the Court, referring to the familiar doctrine as to tax exemptions, said (290 U.S. at page 369, 54 S. Ct. at page 222, 78 L. Ed. 365): "Certainly, Congress did not intend any income from a trust should escape taxation unless definitely exempted." In *Lyeth* v. *Hoey*, 305 U.S. 188, 59 S. Ct. 155, 83 L. Ed. 119, 119 A.L.R. 410, to be sure, the taxpayer won. But there the question was whether the taxpayer, an heir, acquired property "by . . . inheritance," when he received it under an agreement compromising and settling his contest of the decedent's will. The Court

noted that Congress had already imposed a tax upon the transfer of the entire net estate and said (305 U.S. at page 195, 59 S. Ct. at page 159, 83 L. Ed. 119, 119 A.L.R. 410): "Congress has not indicated any intention to tax again the value of the property which legatees, devisees or heirs, received from the decedent's estate." The Court went on to say that the taxpayer obtained the property "because of his standing as an heir", pointing out that, if the will contest "had been fought to a finish" and the taxpayer "had succeeded," the property received by him would have been exempt under the statute, the Court said (305 U S. at page 196, 59 S. Ct. at page 159, 83 L. Ed. 119, 119 A.L.R. 410).

We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption. It does so, because it disregards the heirship which underlay the compromise, the status which commanded that agreement and was recognized by it . . . Respondent agrees that the word "inheritance" as used in the federal statute is not solely applicable to cases of complete intestacy The portion of the decedent's property which petitioner obtained under the compromise did not come to him through the testator's will. That portion he obtained because of his heirship and to that extent he took in spite of the will and as in case of intestacy.

It seems to me that, as thus explained by the Supreme Court, the rationale of *Lyeth* v. *Hoey* is not at all apposite here.[1]

Note

1 How is the treatment of interest altered by § 101(c) and (d) of the 1954 Code? If Judge Frank's view in the *Pierce* case had prevailed, would the $1,000 exclusion of § 101(d) have been applicable? So-called "excess interest" (amounts paid to the beneficiary by the insurer in excess of its contractual obligation because earnings are better than had been anticipated when the contract was made) were fully taxed under the 1939 Code. See Golden, "Taxation of 'Excess Interest' on Life Insurance Proceeds," 31 *Taxes* 818 (1953) What is the status of excess interest under § 101?

2. Note also that the capital sum of $100,000 includes some interest, part of each year's premium was for pure insurance protection and part constituted savings on which a return is earned. If the insured had purchased *term* insurance, the premium on which is less because there is no element of savings, and had deposited the balance in a savings account, the income earned by the deposits would have been taxed to him during his life. The interest component of "ordinary" life insurance, however, is taxed neither to the insured when it is earned nor to the beneficiary when it is paid.

3. The general principle of excluding from gross income the proceeds of life insurance received on the insured's death is qualified by § 101(a)(2), which in the case of a transfer for "a valuable consideration" taxes the transferee on the difference between the proceeds of the policy and the sum of the consideration and premiums subsequently paid by him. What is the justification for this limitation on the general rule of exclusion? The restriction will have a drastic result if a policy is transferred for a consideration that, although "valuable," is small as compared with the face amount of the policy and if the insured dies shortly thereafter. See *James F. Waters, Inc.* v *Commissioner*, 160 F.2d 596 (9th Cir. 1947), cert. den. 332 U.S. 767 (The restriction exempts several types of transfers, one of which was present in the *Waters* case.)

4. If a life insurance policy is surrendered, the tax status of the cash surrender value

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[1] It may well be that, if my interpretation is correct, the case here would come under § 22(b)(2), for it would then be as if the beneficiary had purchased an annuity The result would be to increase the tax beyond that determined by the Commissioner. But, by his determination, he relinquished that increased amount of tax

is governed by § 72(e)(1): the excess of the cash value over the premiums paid is taxable To moderate the impact of a tax at possibly very high rates on a lump sum received in a single year, however, § 72(e)(3) provides that the tax shall be no greater than would have been paid if the cash surrender value had been received ratably over a three-year period. Is there any reason why the interest earned by the investment component of the premiums should be taxed if the policy is surrendered at a profit but excluded if the proceeds of the policy are paid to the beneficiary when the insured dies? The proceeds of a matured endowment policy (unless paid as an annuity) are also taxed like the cash surrender value of a life insurance policy, i e., the excess over the premiums paid is taxable. Why are the earnings on such a contract not excluded in the same manner as the interest component of the proceeds of a life insurance policy?

5. Section 101(b), mentioned *supra*, p. 115, excludes from gross income certain employees' death benefits, not to exceed $5,000 per employee, analogizing the benefits to the proceeds of life insurance. By virtue of § 101(b)(2)(B), the exclusion is not allowed (except in the case of certain qualified employee benefit plans) if the employee possessed just before his death a nonforfeitable right to receive the amount while living. Why?

4. *Annuities*

Note: Section 22(b)(2) of the 1939 Code, governing the taxability of annuity payments, has been entirely rewritten by § 72 of the 1954 Code. The case that follows, decided under the old statute, illustrates the reason for the change.

EGTVEDT v. UNITED STATES

U. S. Court of Claims, 1948

112 Ct. Cl. 80

Littleton, Judge, delivered the opinion of the court:

Plaintiff purchased four annuities in 1937 for $25,000 each, or a total of $100,000, entitling him to aggregate monthly payments of $407, or $4,884 a year, for the balance of his life. Each contract provided that in case of plaintiff's death prior to the receipt by him of a sum equal to the total premium paid, a further sum equal to the balance of the premium would be paid to his wife or to his estate.

Plaintiff seeks to recover income tax deficiencies and interest assessed and collected for 1938 and 1939 on account of the exaction of a tax on a portion of the annuity payments received in those years, on the asserted ground that Section 22(b) (2) of the Revenue Act of 1938 is unconstitutional. In each of the years mentioned the Commissioner of Internal Revenue, pursuant to the explicit requirements of Section 22(b) (2) of the Revenue Act of 1938 . . . , required that of the annuities totaling $4,884 received under the contracts, the amount of $3,000, being an amount equal to 3 per cent of the consideration paid for the annuity contracts, be included in gross income. Plaintiff paid the deficiencies and interest assessed and his claims for refund thereof were rejected.

It will be seen in this case that, as in other cases where the treatment of annuity payments for tax purposes has received judicial attention, the plaintiff has been required to include in gross income the annuity payments received in each year to the extent of an amount equal to 3 per cent of the aggregate consideration paid for the annuity contracts, undiminished by any payments made to the annuitant in prior years in excess of such percentage amount. Therefore, so long as Section 22(b) (2) remains unchanged, the plaintiff, aged 45 and with a normal

life expectancy, on the basis of mortality tables, of about 28 years at the time he purchased the annuities in August 1937, will be required to include in income not only $3,000 of the $4,884 received in each of the years 1938 and 1939, but a like amount in each of the subsequent years of his life, notwithstanding approximately 53 years (100,000÷1,884) will be required, on the basis of such table, for the annual amounts received by plaintiff in excess of $3,000 to aggregate the sum of $100,000 paid for the annuity contracts.

Plaintiff takes the position that the taxing of $3,000 of the $4,884 received by him in each of the years 1938 and 1939 (at which times he had received only a small fraction of the amount he had paid for the annuity policies), necessarily constitutes taxation on an amount which was not income within the meaning of the Sixteenth Amendment, and that insofar as the Revenue Act directs or permits such taxation it is unconstitutional because the tax attempted to be imposed is a direct tax on property without the apportionment required by Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution.

Plaintiff first contends that the full amounts of the annuities received by him in 1938 and 1939 were nothing more than the return to him of a portion of the capital invested in the purchase of the annuities, and hence that until the full purchase price of the annuities of $100,000 has been returned to him, the tax imposed by Section 22(b) (2) is a tax upon capital and not upon income derived from capital. The evidence offered by plaintiff falls far short of supporting this contention....

The evidence shows that from the standpoint of an insurance company each payment represents in part interest on the investment. We cannot, therefore, say that such part is capital, and nontaxable, in the hands of the annuitant. *Klein* v. *Commissioner*, 6 B.T.A. 617, *Guaranty Trust Co.* v. *Commissioner*, 15 B.T.A. 20, and cases cited in footnote 2 [omitted]

Plaintiff next contends that even if it be conceded that some part of each annuity payment was income and, therefore, subject to be taxed, the amount arbitrarily designated by the statute for inclusion in gross income cannot be reconciled with the best evidence available as to what portions of the annuity payments received by him in 1938 and 1939 were, and what portions of the payments received in the future will be, gain derived by plaintiff from his investment of capital in the annuity policies. This contention is based primarily upon the American Annuitants' Male Select Table of Mortality, rated down one year, under which the probability, in August 1937, that plaintiff would survive another 53 years was less than one-half of one per cent. Such mortality tables are used by insurance and annuity companies in determining rates of insurance and annuities for certain groups of people. They are based on a limited number of lives and, while reliable in connection with certain determinations, we think such evidence is not determinative of the question presented. We cannot accept such evidence as sufficient, standing alone, to establish the fact that a substantial portion of the annuity payments received by plaintiff did not constitute income, nor as sufficient evidence to show that the action of Congress in fixing, after a full investigation, the measure of the taxable income in connection with receipt of such annuities was without foundation, wholly arbitrary and, therefore, void under the Sixteenth Amendment. *Cf. Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U.S. 216. . . .

The provision of the Revenue Act of 1938 with which we are here concerned was first enacted in the Revenue Act of 1934 (48 Stat. 680). In its report on H.R. 7835, which became the Revenue Act of 1934, the Ways and Means Committee of the House of Representatives gave the following explanation of its investigations and conclusions in support of the change in Section 213(b) (2) of the 1926 Act, which became Section 22(b) (2) of the 1934 Act. House Report No. 704, 73d Cong., 2d Sess., p. 21 (1939-1 Cum. Bull., Part 2, pp. 554, 569–70):

Section 22(b)(2) Annuities, etc.· The present law does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment. The change continues the policy of permitting the annuitant to recoup his original cost tax-free but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 per cent of the cost of the annuity. While the per cent used is arbitrary, it approximates the rate of return in the average annuity.

Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely The change merely places the return of this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact constitutes income.

See, also, S. Rep. No. 558, 73d Cong., 2d Sess., p. 23 (1939-1 Cum. Bull. (Part 2) 586, 604).

Thus the formula employed by Congress in Section 22(b) (2) for taxing a portion of the payments received from the investment of funds in annuity contracts does not purport to directly charge with a tax the source from which the payments are derived. On the contrary, as stated in *Manne* v. *Commissioner*, 155 Fed(2) 304, at 307,

Congress, in providing that the return from such annuity contracts should be included in the annuitant's gross income to the extent of three per cent of the sum invested by the annuitant, may be said to have made an approximation of that portion of the annuitant's return which is received by him in the form of income from the capital invested.

In holding that the taxpayer in the *Manne* case was, under the facts in that case, in no position to question the constitutionality of Section 22(b) (2) the court stated, at page 307:

. . . A taxpayer claiming that the section of the Revenue Code in question imposes in a given case a tax upon the return of capital under the guise of a tax on income is under the burden of establishing that no income was in fact received by him from his investment, or at least that the income actually received is less than three percent upon his investment. In this case there is no evidence to show that the earnings on the taxpayer's investment were less than three per cent of its amount during the taxable years in question, or to support the inference that the payments received by him were wholly or even partly a return of capital. . . . A taxpayer alleging unconstitutionality of an act must show not only that the act is invalid, but that he has sustained some injury as a result of its enforcement.

With the above-quoted statement of the court in mind, plaintiff now urges that under the facts presented in this case he has sufficiently sustained the burden of proof suggested in the *Manne* case, to show that Section 22(b) (2), to the extent that it undertakes to define as income and tax without apportionment

$3,000 of his annual annuity payments, is unconstitutional as imposing a tax on property which is not income.

We cannot agree, for the reasons already stated, that plaintiff has sufficiently sustained the burden of proof which rests upon him. Moreover, we cannot determine from anything in the evidence what part of the payments periodically made to plaintiff during the taxable years actually represents earnings on the amounts paid by him as consideration for the policies and what part was simply a return of capital. Conceivably, so far as the evidence shows, the earnings on plaintiff's investment may have been, from the standpoint of the insurance companies, adequate to cover those portions of the 1938 and 1939 payments on which the tax in question was imposed. . . .

The weakness of plaintiff's argument lies in the premise that the taxpayer is constitutionally guaranteed the full return of whatever sums he may invest before any part of the proceeds from his investment may be taxed as income, and that until this is assured Congress does not possess the power to designate as income subject to tax without apportionment, any receipts from his invested property which may in the course of events prove to have been derived from the property itself. *Cf. Peabody* v. *Eisner,* 247 U.S. 347, *Stanton* v. *Baltic Mining Co*, 240 U.S. 103.

The view we have taken with respect to plaintiff's premise as a ground for declaring an act of Congress to be unconstitutional is not, in our opinion, contrary to the generally accepted view that in the cases of sales of property the capital must be returned before there is any income to be taxed by way of profit, nor to anything which was said by the court in *Burnet* v. *Logan,* 283 U.S. 404. In that case the court was not deciding the question of whether the income statute involved sought to impose a tax beyond the constitutional power of Congress, but rather the question whether, under the applicable provisions of the statute before the court, certain receipts from a sale were taxable in part as capital. In stating, at page 414, that

> If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment

the court quite obviously was speaking of the situation as it would have existed under the Revenue Act of 1916, wherein amounts received as a return of premiums under annuity contracts were excluded from gross income.

Notwithstanding the absence of any showing of a certainty that Section 22(b)(2) levies a direct tax on capital, the plaintiff, on the strength of what was said in *Burnet* v. *Logan, supra,* and on the basis of the definition of "income" given in *Eisner* v. *Macomber,* 252 U.S. 189, 207, would have us treat the annuity payments to him as, in effect, piecemeal sales of his annuity investments, or as a gradual conversion of a capital asset from one form to another, so as to make it necessary to measure out the return of capital before arriving at any amount as gain derived therefrom. However, we think an investment of funds in an annuity is a transaction which is materially different from an ordinary business transaction entered into for profit where the concept of gain or loss might be applicable. To some extent one who has invested his money in an annuity may be said to have "spent it," that is, to have parted with it in order to obtain con-

tractual rights which are not inherent, in the same degree at least, in the mere ownership of property.

> Elements of value other than the right to receive payments for life are present in an annuity, *e.g.*, security, assurance of income, regularity of payments and relief from responsibility of attending to investment. The experience which actually develops for the annuitant, whatever that may be, extinguishes both the annuity's cost and its expected returns as a capital investment. *Evans* v. *Rothensies*, 114 Fed (2d) 958, 961 . . .

We are unwilling to say that the view of Congress, as indicated by the Committee reports on the enactment in question, that a substantial portion of amounts received under annuity contracts represents income and its finding as expressed in the statute that 3 per cent of such annual payments is a fair approximation of the income in the average annuity, were without foundation. We cannot, therefore, adjudge that Congress transcended the limits of its constitutional power in requiring that plaintiff's annuity payments be included in gross income for tax purposes to the extent provided in Section 22(b) (2) of the Revenue Act of 1938.

> In reaching this conclusion we have recognized the principle, long established and vital in our constitutional system, that the courts may not strike down an act of legislation as unconstitutional, unless it be plainly and palpably so. The statute here involved may be unwise. But an unwise enactment is not necessarily, for that reason, invalid. *Booth* v. *Illinois*, 184 U.S 425, 431.

The plaintiff is not entitled to recover and his petition is therefore dismissed. It is so ordered.

HOWELL, Judge; WHITAKER, Judge; and JONES, Chief Judge, concur.

Note

1. The basic principle of § 72 of the 1954 Code can be illustrated by two examples. Assume that $10,000 in premiums was paid for an annuity contract, and that upon maturity of the policy the obligor is to pay $1,000 annually for 15 years to the annuitant or, should he not survive, to his estate. Under § 72, 2/3 (*i e.*, $10,000 "investment in the contract") divided by ($15,000 "expected return") of each payment would be excluded from income, and the balance would be taxable. Over the contract period, the cost of the contract would be recovered tax-free, and the rest would be taxed. If the obligor under the contract promised to pay $1,000 annually for life to the annuitant, instead of guaranteeing payment for a specified number of years, the "expected return" would be calculated by reference to the annuitant's life expectancy on the annuity starting date. Assuming that his expectancy was then 18 years, the amount to be excluded from income would be 10/18 (*i.e.*, $10,000 "investment in the contract") divided by ($18,000 "expected return") of each payment. Note that in such a situation the amount to be excluded from income over the annuitant's life might be either more or less than the contract's cost. Short-lived annuitants can lose out under the new rule as they could under the 3 per cent rule; long-lived annuitants, who could never exclude more than cost under the 3 per cent rule, now get a chance to beat the government, though this may be of little comfort to those who lose.

2. In application, § 72 may be more complicated than the examples given above. Adjustments will be necessary if (a) amounts have been received under the contract that were tax-free under prior law or under other sections of the 1954 Code, (b) the contract provides for payments that are related to the annuitant's life expectancy but also guarantees that a specific amount will be paid in any event ("refund annuities"), or (c) there is more than one annuitant ("joint and several annuities"), or (d) the contract was transferred for a valuable consideration.

3. By virtue of § 72(f)(1), the annuitant can include as part of his "investment in the contract" any premiums paid by his employer for the contract, if the payments were includible in his income. See the *Drescher* case, *supra*, p 36; § 403(b).

4. See "The Income Tax Treatment of Pensions and Annuities," by the Division of Tax Research, Treasury Department, reprinted in Hearings before the House Ways and Means Committee, 80th Cong., 1st Sess., on Proposed Revision of the Internal Revenue Code, 1947, Part 5, pp. 4001-4004.

5. Compensation for Personal Injuries or Sickness

Note: Section 22(b)(5) of the 1939 Code excluded from gross income compensation for personal injuries or sickness, whether received as damages, under a workmen's compensation act, under a policy of health or accident insurance, or as a military pension or annuity.

Section 104 of the 1954 Code re-enacts § 22(b)(5), except as to amounts received by an employee, through health or accident insurance, that are attributable to contributions by the employer that were not includible in the employee's gross income. Such amounts are taxed to the employee unless they meet the requirements of § 105 of the 1954 Code, which has no counterpart in the 1939 Code.

SIMMS v. COMMISSIONER

U. S. Court of Appeals, District of Columbia Circuit, 1952
196 F 2d 238

Before EDGERTON, WILBUR K. MILLER and FAHY, Circuit Judges.

FAHY, Circuit Judge

Petitioner Joseph B. Simms seeks reversal of a decision of the Tax Court of the United States to the effect that he owes a deficiency of income tax for the year 1945 in the sum of $572.71 His position is that the income which resulted in the tax was in legal contemplation received for physical disability incurred in the line of duty as a member of the Fire Department of the District of Columbia Accordingly, he contends, it was no part of his taxable income because Section 22(b) (5) of the Internal Revenue Code exempts amounts received "under workmen's compensation acts, as compensation for personal injuries or sickness." The respondent, Commissioner of Internal Revenue, ruled that the income was paid to petitioner as a result of his retirement for age and not for disability. If this is right there is no controversy the deficiency is due. The Tax Court agreed with the Commissioner that petitioner was retired for age and therefore his retirement pay is not attributable to disability.

The District of Columbia Code, § 4-501-517, D.C Code (1940), as amended, Supp. VII (1949), provides that firemen may be retired with compensation to be paid from the Policemen and Firemen's Relief fund (1) by reason of permanent disability incurred in line of duty, or (2) after twenty-five years' service, under certain conditions, or, (3) having reached the age of sixty years, in the discretion of the Commissioners.

Petitioner was retired under an order of the Board of Commissioners of the District, dated January 31, 1942, reciting that he and others of the Fire Depart-

ment, "having reached or passed the age of 64 years" are retired, and "are granted relief . . . payable from the Policemen and Firemen's Relief of the District of Columbia. . . ." Petitioner's relief was stated to be the sum of $187.50 per month, which petitioner states was 50% of his salary, in which event it was the maximum permitted by law. § 4-507, D.C. Code (1940). On April 20, 1948, the Commissioners by a further order recited that at the time of his retirement petitioner, and others,

were suffering from physical disabilities which were incurred in the line of duty to such an extent that had they not been retired when they were, for age, they would have been retired for physical disability incurred in the line of active Fire Department duty. . . .

It appears independently that prior to retirement petitioner had suffered physical disability in line of duty. The extent of this disability, however, except that it was permanent, has never been ascertained or translated by administrative action into an award of compensation or retirement pay for disability. See footnote 1, *infra.*

Notwithstanding that both the 1942 and 1948 orders make clear that petitioner was retired not for disability but for age, he contends that since he had become permanently disabled it was the duty of the Commissioners to retire him for disability under § 4-507, D.C. Code (1940).[1] Therefore, he continues, a vested right to disability retirement accrued and the determination made in connection with his retirement that he should receive 50% of his salary is in legal effect an award of that amount for disability. We are unable to accept this view for two reasons. In the first place there has been no determination by the Commissioners of the extent of disability as a basis for fixing an amount of relief for disability. See *Waller* v. *United States,* 1950, 86 U.S. App. D.C. 93, 180 F.2d 194, 16 A.L.R.2d 1328 In the second place, even though, as petitioner argues, the Federal authorities are not bound by the interpretation of the situation made by the District authorities, namely, that he was retired for age, nevertheless it is our view that the correct interpretation for Federal purposes is that petitioner was retired for age. Therefore the income he received as a consequence was not paid to him "under workmen's compensation acts, as compensation for personal injuries or sickness," Section 22(b) (5), supra, and is not excludable from his gross income in the process of arriving at his Federal income tax.

Affirmed.

Note

1. In *Allen* v. *Spencer,* — F.2d — (D C. Cir 1954), a group of retired District of Columbia police and firemen sued the District Commissioners to substitute for their retirement orders based on age and length of service, new orders based on disability. The Court held that any objections to the original orders should have been made in accordance with the prescribed administrative procedures when the orders were issued.

[1] This section reads in pertinent part

"Whenever any member of the . . . fire department of the District of Columbia shall become so permanently disabled through injury received or disease contracted in the line of duty as to incapacitate him for the performance of duty . . ., he shall . . . be retired from the service thereof and be entitled to receive relief from the said policemen and firemen's relief fund, District of Columbia, in an amount not to exceed 50 per centum per year of the salary received by him at the date of retirement . . ."

In *Prince* v. *United States*, 119 F. Supp. 421 (Ct. Cl 1954), the court held that military retirement pay came within § 22(b) (5) of the 1939 Code, although the recipient was retired for age, where he was qualified for retirement (on the same pension) for disability in line of duty Apparently the officer had chosen to be retired for age (in 1943) so as to be eligible for recall to active duty, whereas a disability retirement would have barred a return to duty.

2. The 1954 Code includes a new provision, § 37, granting a credit for "retirement income." The credit, which will be examined further, *infra*, p. 194, is subject to a number of qualifications; the complete exclusion of disability payments, where available, will be more advantageous to the taxpayer.

3. The proceeds of many tort claims will be excluded by § 104. If the injured party recovers a lump sum for medical expenses, pain and suffering, and the loss of past and future earnings, will the entire amount be excluded? Does § 104 serve to exclude amounts paid by a tortfeasor to the taxpayer for loss of consortium or for loss of his child's earning capacity? Would compensation for personal injury be taxable in the absence of § 104? See *supra*, p. 75. A pension, even if not based on disability, may be exempt as a gift. An example is L.O. 1040, C.B. No. 3, p 120 (1920), relating to pensions paid to retired teachers by the Carnegie Foundation for the Advancement of Teaching.

4. The significance of § 104's introductory clause, relating to § 213, will become apparent when § 213 is encountered, *infra*, p. 158.

EPMEIER v. UNITED STATES

U. S. Court of Appeals, Seventh Circuit, 1952
199 F.2d 508

Before MAJOR, Chief Judge, and DUFFY and LINDLEY, Circuit Judges.

LINDLEY, Circuit Judge.

Plaintiff's action to recover an income tax paid by him for the year 1945 having resulted in judgment for defendant, he appeals. The facts are undisputed. For several years, plaintiff had been employed by the Lincoln National Life Insurance Company. During the first six months of 1945, while ill, he was paid by the company, $1800 in sickness benefits. Plaintiff did not include these payments in his income tax return, believing, as he said, that they were exempt from taxation under Section 22(b) (5) of the Internal Revenue Code then in effect. 26 U.S.C. 1946 Ed. § 22(b) (5). The Commissioner, in redetermining the tax liability, included in plaintiff's gross income the entire amount received by him for sickness benefits, resulting in a tax deficit. Plaintiff paid the additional tax assessed, filed a claim for refund, and, upon denial of the latter, brought the present suit.

The employer has statutory authority to engage in the business of insuring risks relating to life and health, and was, in the year 1945, as well as in earlier years, engaged in writing disability insurance as compensation for personal injuries or sickness. It had in effect a life and health insurance plan for its employees, pertinent provisions of which follow.

Those full-time salaried Home and Branch Office employees . . . who, . . . at the time of employment . . pass a satisfactory medical examination, are . . . eligible for free sickness and death benefits. . . Applicants . . . unable to pass . . . may in exceptional cases be engaged as temporary employees, . . . not entitled to sickness . . . benefits If at some future time such temporary employees are able to pass . . . they will be transferred to the permanent salary roll. . . . It is our general rule that an employee whose disability continues beyond expiration of his sickness benefit period, will be

removed from the payroll, and future sickness benefits will not be paid. . . . The administering of the sickness and death benefit plan rests with the Office Administration Department. . . The sickness benefits . . . shall not accrue in favor of any employee who . . . is paid compensation under any Workmen's Compensation Act for illness or disability. . . . The Company, however, will pay to such employee . . the difference between the amount of compensation . . and the amount specified herein, whenever the compensation . . is less than the amount specified herein. . . The Company has provided its employees with an unusually liberal plan of sickness benefits. The payment of these benefits presupposes that the employee is carrying out the instructions of the Company doctor or the employee's private physicians during the period of recuperation. The Company reserves the right to cancel sickness benefits being paid employees, if there is an indication that the fullest cooperation is not forthcoming from the employee . . .

The plan provided also for medical facilities, hospitalization, surgery, retirement plan and life insurance It concluded with the statement that

Constructive suggestions from employees are always welcome Suggestions of the following nature are particularly solicited: Savings in cost of operation, improvements in service to policyholders, expediting the work without decreasing the quality, an increase in business, and improvement in safety and health of employees

Payment of benefits was not required by statute. Plaintiff made no contribution by way of premium other than the labor and service he rendered in his employment.

The only question presented is whether, under Section 22(b) (5) of the Internal Revenue Code, 26 U.S.C. 1946 Ed § 22(b) (5), in effect in 1945 and under the agreed facts, the sickness benefits paid plaintiff, constituted amounts "received through . . . health insurance . . . as compensation for . . . sickness." Plaintiff claims that they are within this statutory definition, while defendant insists that they are not.

Insurance, of ancient origin, involves a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils. Fundamentally and shortly, it is contractual security against possible anticipated loss. Risk is essential and, equally so, a shifting of its incidence from one to another. *Physicians' Defense Co.* v. *Cooper*, 9 Cir., 199 F. 576; *Jordon* v. *Group Health Ass'n*, 71 App. D.C. 38, 107 F.2d 239, *Old Colony Trust Company* v *Commissioner of Internal Revenue*, 1 Cir., 102 F.2d 380, *Alliance Ins. Co.* v. *City Realty Co., D.C.*, 52 F.2d 271; *Meyer* v. *Building & Realty Co.*, 209 Ind. 125, 196 N.E. 250, 100 A.L.R. 1442; 44 C.J.S., Insurance, § 1, p. 471, 29 *Am. Jur.* 47, Sec. 3, 1 Bouvier's *Law Dict.*, Rawle's Third Revision, p. 1613; Webster's *International Dictionary*, 2d Ed. 1942, p. 1289.

In determining whether the benefits under consideration are within the statute and in accord with these general principles, we observe, first, that the plan under which the payments were made is not in the physical form of ordinary formal insurance contracts sold commercially, but instead is included in a company document with other subject matters having to do with the employer-employee relationship. But we know of no reason why insurance protection must be expressed in a formal policy.

True, no money was paid by the employee for the protection, but we think full and complete consideration lay in the contract of employment, by virtue of which, when the employee entered employment and passed a medical examination,

he automatically became insured. In other words, the assumption of the risk involved and indemnity against it were part and parcel of the compensation payable to the employees by the employer. We perceive of no reason why this is not as adequate a consideration for an insurance contract as a specified cash premium. We find no implication in the language of the document that the employer was providing a gratuitous benefit but, on the contrary, the intimation is that the indemnity provided supplemented and added to the terms of employment, by assuring the employees of sickness benefits under the conditions specified.

A medical examination is a common insurance requirement. The distinction, in the plan here, between employees who did not pass and those who did is closely akin to the ordinary insurance requisites of risk measurement and assumption.

Though, as to life insurance benefits, under the plan, each employee was required to name a beneficiary, there was no such requirement for sickness benefits, obviously, however, we think, because they were to be paid only to the employee during his lifetime. The provision for termination satisfies the normal requisite of an insurance contract, by defining the risk in terms of time. Provision is made for instances of successive illnesses, thus defining within definite limitations the total benefits for which the company agrees to be liable. It is provided that in case of payment of workmen's compensation for injuries or illness the company will not pay the benefits except to the extent of any excess in them over the compensation payments The plan warrants no inference that the amount payable represents anything other than sickness benefits, payable only when wages and salaries could not be earned. It makes the basis for the benefits, the length of service and compensation of the employee, factors consistent with the ordinary provisions of a formal insurance contract. The employee is required while ill, to follow the instructions of his physician or the company's physician, a provision closely akin to features of ordinary insurance, where the insurer is interested in avoiding extension of any resulting loss beyond that which can be reasonably avoided. We find in these and other provisions attributes of and incidents to insurance in every sense of the word.

Though the benefits are described as free, if the nature of the contract be given careful consideration, it is readily apparent that the word is used not in the sense of a donation or gratuity but rather with the meaning that no premium other than that included in the employee's services is to be paid. Benefits paid out under such an agreement are obviously a part of the employer's corporate operating costs, which include social security and unemployment taxes, workmen's compensation insurance, employer's liability insurance, maintenance of satisfactory working conditions and many other elements, all of which go into the make-up of the total cost. We conclude that "free" life insurance, "free" sickness benefits, "free" medical facilities, as used here, mean simply that these matters are furnished as additional factors of the employee's compensation, free of any money advancement. The provisions of Section 22(b) (5) undoubtedly were intended to relieve a taxpayer who has the misfortune to become ill or injured, of the necessity of paying income tax upon insurance benefits received to combat the ravages of disease or accident.

As we have indicated, we know of no reason why this insurance, when provided as a part of the contract of employment between employee and employer,

must follow any stereotyped or conventional form. Surely there is no legal magic in form, the essence of the arrangement must determine its legal character. We conclude that the fact that there is no formal contract of insurance is immaterial, if it is clear, as here, that, for an adequate consideration, the company has agreed and has become liable to pay and has paid sickness benefits based upon a reasonable plan of protection of its employees.

The District Court was of the opinion that, though the plan was "an incident of the employer-employee relationship as the plaintiff points out," it did not create a contractual liability to pay "health insurance," as there was no consideration for such a promise. This conclusion, it felt, was supported by the further provision that "the contents" of the document "may be changed from time to time as better thoughts occur."

We have pointed out wherein we think adequate consideration lay in the agreement of employment Though no formal written contract of employment existed, the plan became effective, immediately and automatically, upon the employee's entering service and passing satisfactorily a medical examination. As we view it, all provisions then became binding upon the respective parties. As a consequence, if an employee became ill, he had a right to sickness benefits as a part of his contract. We do not doubt that had the employer refused payment, the employee might have enforced this liability.

The provision that the terms of the agreement may be changed does not impinge upon the soundness of this conclusion. Employment contracts are always subject to revision. If the terms of such changes are not satisfactory to the employee, he may terminate his service; he can not be forced to work under conditions repugnant to his sense of what is fair and proper. It is obvious also, we think, that no change could be made to defeat or lessen the liability, once it had attached. In the provisions lies the implicit agreement to pay the benefits until and unless the terms should be modified; no such modification could reduce the liability for sickness benefits after illness had intervened.

We conclude that the amount paid the taxpayer for sickness benefits was exempt from income tax under the statute. The judgment is reversed with directions to proceed in accord with the announcements herein contained.

Note

1. The taxability of amounts received by an employee through health and accident insurance, where the amounts are paid by the employer or are attributable to contributions by him that were not includible in the employee's gross income, has been substantially changed by § 105 of the 1954 Code. The *Epmeier* case opened up the possibility that an employer might allow executives or stockholder-employees to go to Florida on "sick leave" every winter, without reducing their regular compensation. The Treasury, conscious of this possibility, announced shortly after the case was decided that it would not be followed (Press Release, March 26, 1953, IR-047).

> The statute was originally enacted at a time when provision for compensation for personal injuries or sickness was generally made by individuals by taking out individual policies with insurance companies, the premiums on which were paid out of taxable income. In more recent years many employers have provided a similar type of protection for their employees by making direct payments to them of compensation during periods of sick leave. The Bureau deems that it was the intention of Congress that only payments which are truly "insurance" payments should be excluded from gross income under section 22(b) (5) of the [1939]Code.

In the absence of further clarification from the Congress, the Bureau does not believe that the exclusion under the statute should be extended by administrative action to amounts received by employees as sick leave where such amounts are based in whole or in part on their regular wages on which their fellow employees who are at work are taxable

2. Section 105(e) makes it clear that amounts received under a "plan" of the kind involved in the *Epmeier* case are to be treated as amounts received through accident or health insurance, and the employer need not be an insurance company to qualify. How formal must the employer's practice be to come within the term "plan?" Sections 105(b), (c), and (d) set out the extent of the exclusion of amounts received through health or accident insurance, if paid by the employer or attributable to contributions by him that were not includible in the employee's gross income. Amounts that are not within these exclusions are taxable, § 105(a). Would amounts that come within § 105(c) be taxable as "income" in the absence of this exclusion?

3. Section 106 puts on an equal footing amounts paid by an employer for individual accident and health insurance policies and amounts paid for group policies. Previously, the Internal Revenue Service took the position that payments for individual policies constituted additional compensation to the employees, but that payments for group policies did not.

6. *Tax-Free Interest*

> **Note** Section 22(b)(4) of the 1939 Code, relating to interest on federal, state, and municipal obligations, was re-enacted without substantive change by § 103 of the 1954 Code.
> See Regs. 118, Sec. 39.22(b)(4)-1

COMMISSIONER v. SHAMBERG'S ESTATE

U. S. Court of Appeals, Second Circuit, 1944
144 F.2d 998

Before Augustus N. Hand, Chase and Frank, Circuit Judges.

Augustus N. Hand, Circuit Judge.

This proceeding involves deficiencies in income taxes assessed against Alexander J. Shamberg by the Commissioner of Internal Revenue for the years 1937 and 1938. Shamberg died during the pendency of a proceeding in the Tax Court to review the assessment and his administrator was substituted as a party. The Tax Court determined that there were no deficiencies and the Commissioner filed this petition to review its decision which a majority of this court holds should be affirmed.

The question presented is whether the interest received by Shamberg in the years 1937 and 1938 on bonds of the Port of New York Authority (hereinafter called the "Authority") known as Interstate Bridge and Tunnel Bonds—Series E, and General and Refunding Bonds—First Series, is subject to income taxes. . . .

In the compact pursuant to which the Authority was created the states* agreed to make annual appropriations (not in excess of $100,000 for each state) for expenses of the Authority until revenues from its operations were sufficient to meet its expenses. These annual appropriations were discontinued in 1934 because the revenues from the bridges, the Holland Tunnel and Inland Terminal had become sufficient.

The states have vested in the Authority the power to make and enforce such rules and regulations as it may deem convenient or necessary for the operation

* New York and New Jersey. [Ed.]

and maintenance of the various bridges and tunnels within its jurisdiction. Penalties were provided for their violation, and the inferior criminal courts of the states were given jurisdiction to enforce such penalties.

The State of New York has enacted legislation giving the Authority jurisdiction over all New York residents, corporations and property owners for the purpose of its investigations or hearings in connection with its planning for port improvement, and also for the purpose of all such other action or powers as it may be empowered to exercise. Such legislation further provided that it should have the power to subpoena such persons or corporations, failure to reply being punished in contempt proceedings upon its application to the Supreme Court of New York.

The State of New York has further enacted that the Authority have power to issue orders after hearings requiring obedience of persons subjected to the jurisdiction of the Authority by the statute. The statute further provided that the Authority should have power to enforce its orders by commencing mandamus, injunction, or other appropriate proceedings in the Supreme Court of the state against violators.

In the operation of its bridges and tunnels the Authority maintains a uniformed police force, the members of which are designated by statute as regular police and peace officers of both states. The property of the Authority and the bonds and other securities issued by it are exempt from state taxation in both states. It has the power of condemnation, its employees may join the New York State Retirement System and the Authority has been held to be immune from suit. No tax or assessment is levied within the Port District by or on behalf of the Authority.

The decedent Shamberg, if alive, would have testified at the hearing that he acquired his bonds upon legal advice that the income was immune from federal income tax under the Constitution and that it was further exempt from such taxes under existing statutes and regulations. . . .

The Commissioner first argues that the interest on the bonds of the Authority is taxable under the ruling in *Helvering* v. *Gerhardt*, 304 U.S. 405, 58 S. Ct. 969, 977, 82 L. Ed. 1427.† It is really enough to answer this argument to say that Justice Stone, who wrote the opinion of the majority of the Supreme Court, said in the very last paragraph:

Expressing no opinion whether a federal tax may be imposed upon the Port Authority itself with respect to its receipt of income or its other activities, we decide only that the present tax neither precludes nor threatens unreasonably to obstruct any function essential to the continued existence of the state government.

. . . It is next argued by the Commissioner that in enacting Sec. 22(b) (4) (A) exempting "interest upon . . . the obligations of . . . a State . . . or any political subdivision thereof . . . ," Congress was only excluding from income tax such interest as could not under constitutional doctrines prevailing in 1913, when the exemption act was originally passed, be lawfully taxed. In support of this the Commissioner quotes the statement of Honorable Cordell Hull, who sponsored the measure in the House, in which he said the exemption was inserted "not desiring to raise any Constitutional question or to arouse the antagonism of any of the states." This quotation is relied upon as indicating that Congress

† In this case it was held that a federal income tax on the salaries of employees of the Port Authority was constitutional. [Ed.]

intended to limit the scope of the exemption to income thought at the time to be beyond the taxing power. It is argued in this connection that no such institutions as the Port Authority were then in contemplation of Congress, since the Port Authority (established in 1921) was the first of such bodies to exist. Doubtless it is true that Congress had no such specific form of state organization in mind, but that adds nothing to the solution of the problem. The only question is whether Congress would have intended the exemption to apply if these new forms of state activity had existed; in other words, what, in view of the general setting, is the reasonable interpretation of the words used. That there was no intention strictly to limit the exemption to what was thought to be beyond the taxing power is shown by the statement of Mr. Hull that it was the purpose of the enactment not only to avoid raising "any constitutional questions" but also to avoid arousing "the antagonism of any of the states." We think this statement involved a much broader purpose than to crystallize the constitutional doctrine of that particular time in the statute. Indeed, the existence of any such purpose is negatived by the fact that the limitations of constitutional power were by no means certain or thought to be certain at the time the act was passed. It seems to us entirely unreal to limit what we believe was the broad purpose to exempt the bonds of states and their agencies when engaged in customary governmental activity, particularly when one of the main purposes of the exemption provision was to facilitate the passage of the Sixteenth Amendment. . . .

The Commissioner also relies on *State of South Carolina* v. *United States*, 199 U.S. 437, 26 S. Ct. 110, 50 L. Ed 261, 4 Ann. Cas. 737, as indicating that the exemption should not be applied to state activities which are not wholly essential to its sovereignty. The argument is based on the claim that the exemption provision must be interpreted in the light of that decision, which it is said governed the extent of the constitutional power to tax at the time when the exemption statute was enacted. We have already said that, in our opinion, the exemption provision was not limited to cases where federal taxation was constitutionally possible in 1913, but covered a broader field where taxation of obligations was doubtful and subject to contention by the states. But even assuming the government's interpretation of the exemption provision as merely enacting the constitutional doctrine as of 1913, we do not think that the *South Carolina* case would permit taxation of such a state agency as the Port Authority. That decision related only to the power of the government to impose the usual license taxes upon dispensaries established by the state for the wholesale and retail sale of liquor. It held that such a state agency was subject to the tax, and that the constitutional limitation did not extend to instrumentalities used by the state in carrying on an ordinary private business. This was plainly a commercial business which resulted in one year of a profit of about $500,000 which was divided between the state and local municipalities. Such a holding seems to us far from indicating that it was ever applicable to agencies having customary governmental activities, such as development of roads, bridges, and waterways entered upon with no profit motive. . . .

But the regulation we have quoted [now 39.22(b)(4)-1 of Regs. 118] makes our position still clearer. It defines political subdivision as one "to which has been delegated the right to exercise part of the sovereign power of the State," and while it says it may for the purpose of exemption include "special assessment

districts . . . such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of the State," it does not preclude political subdivisions which do not possess the power of taxation but generally exempts interest on "Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations."

We think that this regulation covered bonds of such a public body as the Authority, and was within the scope of the statute. When it gave immunity to bonds issued "on behalf of" the state as well as those issued by the state itself, those words certainly meant something in addition to the words "issued by," and what can the added words refer to except bonds issued by a state agency to carry out a public purpose where the latter is not named as obligor on the bonds. We need not claim that this public purpose may be a commercial enterprise for mere profit, as distinguished from a public activity of the traditional sort in which the Authority is engaged. It has many times been held that bonds issued by municipalities are within the exemption of Sec. 22 (b) (4) (A) even though payment is to be made only out of special funds and the credit of the municipalities was not pledged....

Order affirmed

[The dissenting opinion of FRANK, Circuit Judge is omitted.]

Note

1. While § 103(a) raises troublesome questions of interpretation in such borderline circumstances as these, it points up far more important issues of constitutionality and policy. Must the federal government grant an exemption to the interest on state and municipal bonds? Rottschaefer, "Federal Taxation of State and Municipal Bond Interest," 20 *N.C.L. Rev.* 141 (1942); Rakestraw, "The Reciprocal Rule of Governmental Tax Immunity—A Legal Myth," 3 *Okla. L. Rev* 131(1950). If the exemption is a matter of grace, can it be defended? Note first that high bracket taxpayers can derive an unusual benefit by investing in "tax exempts." The table below (adapted from the Prentice-Hall Lawyer's Weekly Report, May 4, 1953) shows the rate of *taxable* interest that would be required to produce a "take-home" or after-tax yield of 2 per cent and 4 per cent for a married couple at various levels of taxable income under the 1952 rates.

Taxable income* (married couple joint return)	Tax bracket rate (1952) per cent	TAX-EXEMPT BOND YIELD 2%	4%
		Rates of taxable interest necessary to yield same amount after tax	
$4,000	22.2	2.57	5.14
$ 4,000– 8,000	24.6	2.65	5.32
16,000– 20,000	38.0	3.23	6.45
76,000– 88,000	72.0	7.14	14.29
100,000–120,000	77.0	8.70	17.39
400,000–	92.0	25.00	50.00

*After deductions and personal exemptions The table assumes that the amount of tax-exempt interest, when excluded from taxable income, would not bring the taxpayer into a lower bracket. If it did, the advantage would be slightly less than shown. In each line the bracket rate applies to amounts over the first income figure and not over the second

For the higher brackets, it is clear that no industrial or other private bonds can compete with the tax-exempts in net yield. By the same token, however, the state or

municipality is enabled to sell its securities at a lower interest cost. Whether these issuers gain as much as the Federal government loses is an open question. One writer has pointed out the possibility that federal taxation of state and municipal bond interest, while increasing the progressivity of the federal tax, might cause state and municipal agencies to rely more heavily on regressive taxes or to reduce services to lower income groups. Bronfenbrenner, "Economic Effects of the Taxation of Government Securities," 35 *Ill. L Rev.* 293 (1940). The questions of policy were vigorously debated in 1942 before the House Committee on Ways and Means, when the Treasury campaigned unsuccessfully for a repeal of §22(b)(4) Hearings on Revenue Revision of 1942, House Committee on Ways and Means, 77th Cong., 2d Sess., Vol. 2, pp. 1479–1610, Vol. 3, pp. 3079–3160; see also Hearings on H R. 7378, Senate Finance Committee, 77th Cong., 2d sess., Vol 1, pp. 539–673; Simons, *Personal Income Taxation* (1938) 170–184.

See Butters, Thompson, and Bollinger, *Effects of Taxation. Investments by Individuals* (1953), which, after a study of the holdings of tax-exempt securities by wealthy investors, concludes (p. 298) that the tax structure provides a strong incentive for such individuals to invest in tax-exempt securities but that their holdings are substantially smaller than might have been anticipated·

> Among the factors responsible for the failure of top bracket individuals to exploit fully this opportunity of receiving tax-exempt income, the following appear to have been important· the failure of these securities as a class to offer much opportunity for capital appreciation in recent years, their low yield at 1949 interest rates; the specialized knowledge which is required for intelligent investments in state and local bonds, and fear of capital loss from such investments.

At several points the Code strikes indirectly at tax-exempt bonds. Interest on loans to buy or carry such securities may not be deducted, *infra*, p. 178. Other expenses (such as safe deposit box rentals, fees for investment advice, *etc.*) related to such securities are disallowed by § 265(1). See *National Life Ins. Co.* v. *United States*, 277 U.S. 508 (1928); Powell, "The Remnant of Intergovernmental Tax Immunities," 58 *Harv. L. Rev.* 757, 796–803 (1945).

2. In recent years there has been a growing use of "industrial" municipal bonds—issued to finance the construction of factories that are then rented to private industries. Often the municipality's credit is not pledged, the bonds being payable from the rentals. An unusual provision of one such issue is that the bonds may be converted by the holder into the common stock of the lessee enterprise. Can tax immunity be defended for such bonds? See Note, 66 *Harv. L. Rev.* 898, 904–906. Private real estate investors may find it hard to compete with real estate developments that are financed by tax-exempt bonds, especially since the rentals paid to the municipality (out of which the interest and principal are to be paid) are also tax exempt. A somewhat analogous attempt to exploit the tax exemption of charitable organizations was eliminated by the Revenue Act of 1950 See Brown, "The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes," 13 *U. of Pitt. L Rev.* 623 (1952). The House version of the 1954 Code included a provision prohibiting the deduction of rent paid for the use of property acquired or improved by the issue of so-called industrial development revenue bonds (where the credit of the issuing authority was not pledged), but the Senate would not agree and the provision was eliminated. The Conference Report states that "it is recognized that a serious abuse may be developing where the Federal income tax exemption granted interest on State and local governmental obligations is used for purposes of attracting new industry," but that the proposal might "have had the unintended result of affecting adversely certain proper governmental functions, such as the operation of municipal wharf and storage facilities, municipal airports, and similar operations" H. Rept. No. 2543, 83d Cong., 2d sess., p 33. See Ratchford, "Revenue Bonds and Tax Immunity," 7 *Nat'l. Tax J.* 40 (1954).

3. The salaries of state and municipal officers and employees are no longer immune to federal taxation. The Port of New York Authority was the guinea pig for Treasury experimentation here too; in the *Gerhardt* case, cited above, it was held as to employees of the Authority that,

> A nondiscriminatory tax laid on their net income, in common with that of all other members of the community, could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken, or to obstruct it more than like private enterprises are obstructed by our taxing system. Even though, to some unascertainable extent, the tax deprives the states of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as states. At most it may be said to increase somewhat the cost of the state governments because, in an interdependent economic society, the taxation of income tends to raise (to some extent which economists are not able to measure, see *Indian Motorcycle Co.* v. *United States*, 283 U.S. 570, 581, 51 S. Ct. at 605, footnote 1) the price of labor and materials. The effect of the immunity if allowed would be to relieve respondents of their duty of financial support to the national government, in order to secure to the state a theoretical advantage so speculative in its character and measurement as to be unsubstantial. A tax immunity devised for protection of the states as governmental entities cannot be pressed so far. (304 U.S. 405, 420).

Thereafter the federal income tax was levied on all state and municipal officers and employees, at the same time Congress consented (by Title I, Section 4 of the Public Salary Tax Act of 1939, 53 Stat. 575) to state taxation of its officers and employees. Shaw, "The Public Salary Tax Act of 1939," 27 *Calif. L. Rev.* 705 (1939). There has never been an attempt, however, to tax the state's *own* income. See § 115. Could any part of such income be constitutionally taxed? See *New York* v *United States*, 326 U.S 572 (1946). Section 511(a)(2)(A) imposes a tax on the "unrelated business income" (*e.g.*, that derived from industrial or commercial activity) of state colleges and universities. See Chapter 7, Sec. C.

4. The interest on all obligations of the United States and its instrumentalities issued after March 1, 1941, when the Public Debt Act of 1941 was enacted, is fully subject to federal income tax. Many pre-1941 obligations, however, are exempt from the normal tax, and a few are exempt from both normal tax and surtax. Partially tax-exempt interest is responsible for the now otherwise inexplicable dual system of normal tax and surtax, a system which outlived its usefulness when the exemptions, once higher for the surtax than for the normal tax, were equalized.

Before the enactment of the 1954 Code, the statute provided that the normal tax should be computed on "normal tax net income" (including partially tax-exempt interest) and the surtax on "surtax net income" (excluding such interest). The 1954 Code achieves the same result with greater simplicity by combining the normal tax and surtax and imposing both upon "taxable income" (including partially tax-exempt interest), and then allowing (Section 35) a credit of 3 per cent (the normal tax rate) for such interest. To satisfy the terms of such obligations, it is still necessary to designate part of the income tax as normal tax (from which the obligations are exempt) and the rest as surtax This is done in § 1(a).

5. An interesting, but minor, episode in this constitutional area is the taxability of the salaries of federal judges The last sentence of § 22(a) of the 1939 Code explicitly included* all judicial salaries. Article III, Section 1, of the Constitution provides that federal judges "shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office." This injunction, it was held in 1920, prohibited the levy of a federal income tax on a judge's salary; the judge in question had been appointed in 1899, but the Court did not rest its decision on the fact that his appointment antedated the income tax. *Evans* v. *Gore*, 253 U.S. 245 (1920). The subsequent litigation on this subject is reviewed in *Baker* v. *Commissioner*, 149 F.2d 342 (4th Cir. 1945), cert. denied 326 U.S. 746, holding that "a judge who takes office under an established Congressional policy of taxing his salary becomes entitled only to the salary prescribed by statute less income taxes . . ." Such a policy was established by Congress in the Revenue Act of 1918, the court also held that a post-1918

* The clause was omitted from § 61 of the 1954 Code as unnecessary.

increase of rates, or a restoration of tax after a reduction, did not improperly diminish the salary. *Evans* v. *Gore,* therefore, could have continued vitality only for the vanishing tribe of pre-1918 judges. Referring to that case, Holmes once wrote.

This morning brings a surprise—I was notified some time ago that prepayment of tax by companies issuing bonds counted as part of my income [see *infra,* p. 75] and that a small additional tax was due from me for two past years. I wrote back that I should pay as soon as I received my bill and that I didn't know it made any difference that by the decision of our court (I dissenting) I had overpaid by some thousands, as my salary was taxed. Answer comes that if I apply for a refund of it I shall receive prompt attention—I don't quite know whether to or not. The wiley [sic] Brandeis has had overpayment credited on a tax, I believe" 1 *Holmes-Laski Letters* (1953) 335–6.

Judge L. Hand has also written on *Evans* v. *Gore.*

Again I have pondered on what it is to be a Bolshevik, and once I learned There was a time when Congress thought it could reach the salaries of my brothers and myself by an income tax, until the Supreme Court manfully came to our rescue. A judge of much experience was talking with me one day about it, I was wrong enough in my law, as it afterwards turned out, and disloyal enough in temper to my class, to say that I thought the tax valid "Do you know anything about it?" he asked with some asperity "No," said I, "not a thing." "Have you ever read Taney's letter?" "No," said I again, for I was innocent of any learning. "Why, they can't do that," said he, "they can't do that, that's Bolshevism." And so it turned out, to my personal gratification, since when, freed from that Red Peril, I have enjoyed an immunity which the rest of you, alas, cannot share. [This was written in 1930.] Far be it from me to suggest that there are graver thrusts at the structure of society than to tax a Federal judge. Properly instructed, I have recanted my heresy, and yet there hangs about "Bolshevism" a residual vagueness, a lack of clear outline, as of a mountain against the setting sun, which only goes to show, I suppose, that a fundamentally corrupt nature can never be wholly reformed. L. Hand, *The Spirit of Liberty* (Dillard ed.) (1953) 77–78

7. *Non-taxable Exchanges*

Note· Section 112(n) of the 1939 Code, somewhat modified, was carried over as § 1034 of the 1954 Code. See Regs. 118, Sec. 39.112(n)-1.

HOUSE COMMITTEE ON WAYS AND MEANS,

82D CONG., 1ST SESS., H. REPT. No. 586

(reprinted in 51-2 C B. 357, 377)

Section 303* of this bill amends the present provisions relating to a gain on the sale of a taxpayer's principal residence so as to eliminate a hardship under existing law which provides that when a personal residence is sold at a gain the difference between its adjusted basis and the sale price is taxed as a capital gain. The hardship is accentuated when the transactions are necessitated by such facts as an increase in the size of the family or a change in the place of the taxpayer's

* The recommended provision became § 112(n) of the 1939 Code, somewhat modified, it is § 1034 of the 1954 Code. The bill was amended by the Senate to allow the taxpayer 18 months to occupy a newly constructed residence, instead of the 12 month period otherwise required The reason for this change was the Senate Finance Committee's feeling that "in the case of new construction the requirement of occupancy within 1 year appears . . not to be realistic, particularly during the present period of material and labor shortages." S Rept No. 781, 51-2 C B 458, 483.

employment. In these situations the transaction partakes of the nature of an involuntary conversion. Cases of this type are particularly numerous in periods of rapid change such as mobilization or reconversion. For this reason the need for remedial action at the present time is urgent.

Section 303 of this bill provides that when the sale of the taxpayer's principal residence is followed within a period of 1 year by the purchase of a substitute, or when the substitute is purchased within a year prior to the sale of the taxpayer's principal residence, gain shall be recognized only to the extent that the selling price of the old residence exceeds the cost of the new one. Thus, if a dwelling purchased in 1940 for $10,000 is sold in 1951 for $15,000, there would ordinarily be a taxable gain of $5,000 under existing law. Under this bill no portion of the gain would be taxable provided a substitute "principal residence" is purchased by the taxpayer within the stated period of time for a price of $15,000 or more. If the replacement cost is less than $15,000, say $14,000, the amount taxable as gain will be $1,000.

This special treatment is not limited to the "involuntary conversion" type of case, where the taxpayer is forced to sell his home because the place of his employment is changed. While the need for relief is especially clear in such cases, an attempt to confine the provision to them would increase the task of administration very much.

Note

1. Is § 1034 always advantageous to the taxpayer?

2. Section 1034 is modelled to some extent on § 1033. This section, which was introduced in an earlier form by the Revenue Act of 1921, provides that gain shall not be recognized if property is "compulsorily or involuntarily converted" (*i.e.*, destroyed, stolen or taken by eminent domain) and if the proceeds (*e.g.*, from damages or insurance) are used to acquire a similar property. The gain is "postponed" rather than obliterated, however, as a result of a corresponding "basis" provision, § 1033(c). As in the case of a new residence under § 1034, the newly acquired property (assuming that it costs exactly the same as the proceeds of the old) takes over the basis of the old property. It is possible, however, that the postponed gain will never be taxed. For one such situation, look again at § 1014(a).

3. See also § 1031(a). Note that it is limited to a barter and that, unlike §§ 1033 and 1034, it provides for the non-recognition of loss as well as gain. It has had a substantial impact on real estate transactions, since it permits the taxpayer to avoid recognizing a gain on a factory, for example, that is no longer suitable if he can exchange it for another. A sale of the old followed by purchase of a new plant will not qualify.

4. There are a number of other exchanges, especially of corporate securities, that do not give rise to gain or loss because of "non-recognition" provisions. Some of them will be taken up later.

Whenever the student encounters a "non-recognition" provision, he should be alert for a related provision assigning a "substituted" basis to the property whose acquisition causes the non-recognition of gain or loss.

Section B. Personal Deductions

Chapter 1 and Section A of this Chapter have set the stage for determining the taxpayer's *gross* income. Chapter 1 demonstrated how broad is the definition of

§ 61 and how diverse are the events that may give rise to income, it also showed that there are constitutional boundaries to what may be taxed. Section A of this Chapter was concerned primarily with certain receipts that Congress has chosen to exclude from gross income, notwithstanding its power to tax them, or most of them, if it chose. Both Chapter 1 and Section A of this Chapter are illustrative rather than exhaustive.

Once the taxpayer's *gross* income is ascertained, it becomes necessary to tabulate his deductions in order to arrive at *taxable* income. For it is *taxable* income upon which the tax itself is levied.

In listing the taxpayer's deductions, the student should always keep in mind that deductions are permissible only when authorized by statute or regulations. One of the most common errors into which the tyro can fall is to assume expenses and losses are deductible unless specifically denied, just as all income is caught up by § 61 unless excluded by statute or Constitution. If you sell your home at a loss, you will look in vain for a statute or regulation forbidding you—at least in terms more specific than § 262 to deduct the loss. It is nevertheless non-deductible, for it is not specifically authorized. This is an illustration of the old stereotype of the German attitude toward liberty. whatever is not permitted by law is forbidden.

Even when a deduction is found in the Code, the taxpayer will often be confronted by the adage that deductions are to be strictly construed against him. Why? Would it be more appropriate to apply the canon of construction advocated by Mr. Justice Holmes (on circuit) in *Johnson* v. *United States*, 163 F. 30, 32 (1st Cir. 1908):

> The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.

See Griswold, "An Argument against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace," 56 *Harv. L. Rev.* 1142 (1943).

For purposes of pedagogical convenience, the deductions allowed by the Code have been divided into two groups:

(1) *Personal deductions.* These deductions (including such items as medical expenses, alimony, interest, certain taxes, and others) are taken up in the pages that immediately follow this Note. This group is characterized by the fact that the taxpayer need not be engaged either in business or in a profit-making transaction to qualify for the deduction.

Another point of importance about this first group of deductions is that the taxpayer is granted an option with respect to them. He can either itemize them on the tax return or elect instead to take the "standard deduction" provided by §§ 141-144. (Election of the standard deduction also entails a waiver of certain credits. See § 36.) This optional deduction is 10 per cent of the taxpayer's "adjusted gross income" (roughly speaking, gross income less most business and similar expenses) but not to exceed $1000 or, in the unusual case of a married person filing a separate return, $500. Thus, if the taxpayer's personal deductions are small, or if he does not wish to trouble himself with an

itemization, he may elect the standard deduction. The standard deduction was adopted in 1944 as a means of simplifying the tax return, it does that, and for many taxpayers who are convinced that to itemize will be profitless it does away with the need to keep a record of these personal expenses. There is some risk in such a calculus, however, since one cannot be sure until the end of the year how great one's personal deductions will be. If the Christmas tree starts a fire, giving rise to a deduction for the property loss, a taxpayer who had planned to take the standard deduction may find out—too late to substantiate personal expenses paid in earlier months—that an itemization would be more advantageous.

(2) *Business deductions.* These deductions, which will be taken up in Chapter 3, arise in the course of the taxpayer's "trade or business" (a phrase that includes professions and other occupations) or in a transaction entered into for profit. Roughly speaking, the taxpayer is allowed to deduct all ordinary expenses and losses that grow out of his business and his transactions for profit. The standard deduction mentioned above may be elected *in addition to* the taxpayer's business deductions (with some minor exceptions noted in Ch. 3, Sec C.). As already seen, election of the standard deduction displaces *all* personal deductions

The standard deduction is widely used. For the taxable year 1949, it was claimed in lieu of an itemization of deductions on 42 out of 52 million returns, or 81 per cent. The use of the standard deduction is especially prevalent on the smaller returns and declines as income rises, since it may never exceed $1,000 Even so, about two-thirds of the taxable returns reporting adjusted gross income of $10-11,000 employ the standard deduction and almost one-half of those reporting $15-20,000 of adjusted gross income do so. The fraction declines to about one-tenth for returns with $50-60,000 of adjusted gross income.

It should be noted that the availability of the standard deduction depreciates the value of the personal deductions. Before it was adopted, the taxpayer who made charitable contributions or paid interest on a mortgage or real property taxes on his home received a tax concession that another taxpayer with equal income who made no contributions and rented a home did not get. Now, however, the two taxpayers will be on a par if the former one does not have personal deductions exceeding the standard deduction; and even if his deductions do exceed the standard deduction, the disparity between them is not as great as it was. To the extent that the personal deductions are a conscious instrument of policy, designed to encourage home ownership or philanthropy, their effect is less pronounced than before the standard deduction was created.

1. *Extraordinary Medical Expenses*

> ***Note:*** **Section 23(x) of the 1939 Code, allowing a deduction for extraordinary medical expenses, has been carried over, with several modifications, by § 213 of the 1954 Code.**

OCHS v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1952
195 F.2d 692

Before Augustus N. Hand, Chase and Frank, Circuit Judges.

Augustus N. Hand, Circuit Judge.

The question raised by this appeal is whether the taxpayer Samuel Ochs was entitled under Section 23(x) of the Internal Revenue Code to deduct the sum of

$1,456 50 paid by him for maintaining his two minor children in day school and boarding school as medical expenses incurred for the benefit of his wife. . . .

The Tax Court made the following findings.

"During the taxable year petitioner was the husband of Helen H. Ochs. They had two children, Josephine age six and Jeanne age four.

"On December 10, 1943, a thyroidectomy was performed on petitioner's wife. A histological examination disclosed a papillary carcinoma of the thyroid with multiple lymph node metastases, according to the surgeon's report. During the taxable year the petitioner maintained his two children in day school during the first half of the year and in boarding school during the latter half of the year at a cost of $1,456.50. Petitioner deducted this sum from his income for the year 1946 as a medical expense under section 23(x) of the Internal Revenue Code.

"During the taxable year, as a result of the operation on December 10, 1943, petitioner's wife was unable to speak above a whisper. Efforts of petitioner's wife to speak were painful, required much of her strength, and left her in a highly nervous state. Petitioner was advised by the operating surgeon that his wife suffered from cancer of the throat, a condition which was fatal in many cases. He advised extensive X-ray treatment after the operation. Petitioner became alarmed when, by 1946, his wife's voice had failed to improve, and believed that the irritation and nervousness caused by attempting to care for the children at a time when she could scarcely speak above a whisper might cause a recurrence of the cancer. Petitioner and his wife consulted a reputable physician and were advised by him that if the children were not separated from petitioner's wife she would not improve and her nervousness and irritation might cause a recurrence of the cancer. Petitioner continued to maintain his children in boarding school after the taxable year here involved until up to the end of five years following the operation of December 10, 1943, petitioner having been advised that if there was no recurrence of the cancer during that time his wife could be considered as having recovered from the cancer.

"During the taxable year petitioner's income was between $5,000 and $6,000. Petitioner's two children have not attended private school but have lived at home and attended public school since a period beginning five years after the operation of December 10, 1943 Petitioner's purpose in sending the children to boarding school during the year 1946 was to alleviate his wife's pain and suffering in caring for the children by reason of her inability to speak above a whisper and to prevent a recurrence of the cancer which was responsible for the condition of her voice. He also thought it would be good for the children to be away from their mother as much as possible while she was unable to speak to them above a whisper.

"Petitioner's wife was employed part of her time in 1946 as a typist and stenographer. On account of the impairment which existed in her voice she found it difficult to hold a position and was only able to do part-time work. At the time of the hearing of this proceeding in 1951, she had recovered the use of her voice and seems to have entirely recovered from her throat cancer."

The Tax Court said in its opinion that it had no reason to doubt the good faith and truthfulness of the taxpayer and that his devotion and consideration for his wife were altogether admirable, but it nevertheless held that the expense of sending the children to school was not deductible as a medical expense under the provisions of Section 23(x) and Regulations 118, Sec. 39.23(x)-1.

In our opinion the expenses incurred by the taxpayer were non-deductible family expenses within the meaning of § 24(a)(1) [§ 262, 1954 Code] rather than medical expenses. Concededly the line between the two is a difficult one to draw, but this only reflects the fact that expenditures made on behalf of some members of a family unit frequently benefit others in the family as well. The wife in this case had in the past contributed the services—caring for the children—for which the husband was required to pay because, owing to her illness, she could no longer care for them. If, for example, the husband had employed a governess for the children, or a cook, the wages he would have paid would not be deductible. Or, if the wife had died, and the children were sent to a boarding school, there would certainly be no basis for contending that such expenses were deductible. The examples given serve to illustrate that the expenses here were made necessary by the loss of the wife's services, and that the only reason for allowing them as a deduction is that the wife also received a benefit. We think it unlikely that Congress intended to transform family expenses into medical expenses for this reason. The decision of the Tax Court is further supported by its conclusion that the expenditures were to some extent at least incurred while the wife was acting as a typist in order to earn money for the family. We do not think that the decisions discussed in the opinion of the Tax Court and the briefs of the parties have any real bearing upon the issues involved in this appeal.

The decision is affirmed.

FRANK, Circuit Judge *(dissenting).*

Humane considerations in revenue laws are undeniably exceptional. But there is no good reason why, when, for once, Congress, although seeking revenue, shows it has a heart, the courts should try to make it beat feebly. Here is a man earning between $5,000 and $6,000 a year. His wife was operated on for cancer three years earlier and has still not regained the use of her voice. The doctor says that she will not get any better—may indeed have a recurrence of the cancer, this time surely fatal—unless she is separated from her two children, aged six and four. The children are young, healthy, active and irrepressible; their mother cannot speak above a whisper without pain. She becomes ever more nervous and irritable when they are around, her voice does not improve when it should. The father (instead of sending her to a sanitarium) sends the children away to school and seeks to deduct the cost therefor as a "medical expense."

The Commissioner, the Tax Court, and now my colleagues, are certain Congress did not intend relief for a man in this grave plight. The truth is, of course, no one knows what Congress would have said if it had been faced with these facts. The few paltry sentences of Congressional history for § 23(x) do not lend strong support—indeed any support at all—to a strict construction theory:

> This allowance is granted in consideration of the heavy tax burden that must be borne by industry during the existing emergency and of the desirability of maintaining the present high level of public health and morale. . . . The term "medical care" is broadly defined to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. It is not intended, however, that a deduction should be allowed for any expense that is not incurred primarily for the prevention or alleviation of a physical or mental defect or illness.[1]

[1] Sen. Rep. 1631, 77th Cong., 2d Sess. (1942) 95–96

I think that Congress would have said that this man's expense fell within the category of "mitigation, treatment, or prevention of disease," and that it was for the "purpose of affecting [a] structure or function of the body." The Commissioner argued, successfully in the Tax Court, that, because the money spent was only indirectly for the sake of the wife's health and directly for the children's maintenance, it could not qualify as a "medical expense." Much is made of the fact that the children themselves were healthy and normal—and little of the fact that it was their very health and normality which were draining away the mother's strength. The Commissioner seemingly admits that the deduction might be a medical expense if the wife were sent away from her children to a sanitarium for rest and quiet, but asserts that it never can be if, for the very same purpose, the children are sent away from the mother—even if a boarding-school for the children is cheaper than a sanitarium for the wife. I cannot believe that Congress intended such a meaningless distinction, that it meant to rule out all kinds of therapeutic treatment applied indirectly rather than directly—even though the indirect treatment be "primarily for the . . . alleviation of a physical or mental defect or illness." [2] The cure ought to be the doctor's business, not the Commissioner's.

The only sensible criterion of a "medical expense"—and I think this criterion satisfies Congressional caution without destroying what little humanity remains in the Internal Revenue Code—should be that the taxpayer, in incurring the expense, was guided by a physician's bona fide advice that such a treatment was necessary to the patient's recovery from, or prevention of, a specific ailment.

Indeed, a test for § 23(x) applicability, much akin to the one I have in mind, was adopted by the Tax Court in *Havey* v. *Commissioner*, 12 T.C. 409, 412:

> In determining allowability, many factors must be considered. Consideration should be accorded the motive or purpose of the taxpayer, but such factor is not alone determinative. To accord it conclusive weight would make nugatory the prohibition against allowing personal, living, or family expenses. Thus also it is important to inquire as to the origin of the expense. Was it incurred at the direction or suggestion of a physician; did the treatment bear directly on the physical condition in question, did the treatment bear such a direct or proximate therapeutic relation to the bodily condition as to justify a reasonable belief the same would be efficacious; was the treatment in proximate time so near to the onset or recurrence of the disease or condition as to make one the true occasion of the other, thus eliminating expense incurred for general, as contrasted with some specific physical improvement.

This taxpayer can, I think, meet every requirement of the *Havey* test. (1) *Motive:* Ochs could have no motive but his wife's health in sending the children away. They had never attended before—nor have they attended since—private

[2] The Commissioner has, in the past, shown more liberal tendencies in sanctioning somewhat unorthodox kinds of treatment as contemplated by the statute· He has allowed the deduction of fees paid to chiropractors and Christian Science practitioners. I T 3598, 1943 CB 157. Bureau letter, February 2, 1943. 433 CCH, Fed. Tax Rep. § 6175. He should not, in this context, lag behind the progress of the medical art. Especially in this case should the Commissioner realize the growing emphasis placed by medical practitioners upon peace of mind as a major factor in the recovery of patients from what were formerly thought to be entirely organic diseases. If the wife here had been recovering from a nervous breakdown, it could not be sensibly argued that the cure did not fit the disease. Are we ready now to discount the uncontroverted evidence of the doctor in this case that peace of mind and body (it takes not only mental but physical gymnastics to keep up with two children aged four and six) was essential to recovery from, and prevention of, a throat cancer?

schools. A man earning less than $6,000 with three dependents would not normally send his children to boarding-school. The four-year-old would most likely have stayed home; the six-year-old, if she went to school at all, would have gone to a free public school. Day school and boarding-school were indispensable only because they filled up the children's play and leisure hours—when they would have harassed their mother. The Commissioner doesn't argue that Ochs chose a more expensive school than he had to; nor even that the wife might have been more economically sent away from home. He does suggest, however, that, since the change benefitted the children as well as the mother, it cannot be considered a medical expense because not incurred solely for the mother's recovery. Congress required only that medical expenses be "primarily" for the patient's recovery. The evidence here, moreover, establishes (and the Tax Court so found) that the effect on the wife's health was the sole consideration inducing her husband's action even if it was not the sole result. (2) *Doctor's advice:* Ochs' action was precipitated by the strong warning of a physician. The doctor predicted that the wife might not recover if the children stayed at home. (3) *Relation between illness and treatment:* The physician advised sending the children away because their presence required vocal exertion on the mother's part—strain and pain in the vulnerable throat region. The advice was aimed to aid the mother's specific throat condition and not just her general well-being or disposition. The physician's warning was certainly ominous enough to instill in the taxpayer a "reasonable belief that the 'treatment' would be efficacious." (4) *Proximity in time of treatment to illness:* The children were sent away as soon as possible after the doctor's advice. They were kept in schools until the five-year danger period of cancer recurrence was over. Then they were brought home, and have never been to private schools since. It is true that the children were kept at home for three years after the cancer operation. But the doctor who counseled their separation was not consulted until 1946, when Mrs. Ochs' lack of improvement became very noticeable.[3]

In the final analysis, the Commissioner, the Tax Court and my colleagues all seem to reject Mr. Ochs' plea because of the nightmarish spectacle of opening the floodgates to cases involving expense for cooks, governesses, baby-sitters, nourish-

[3] See how these tests have been applied in other § 23(x) cases Usually when such deductions are disallowed, the taxpayers have failed to prove that the expenses were incurred primarily to alleviate a specific illness of the body or mind, i e, they have not met the motive-test or the relation-test laid down in *Havey.*

The majority of § 23(x) cases seem to have dealt, strangely enough, with Florida or Arizona winter vacations. One taxpayer closed up his business after a coronary occlusion and, in effect, retired to Florida. He wanted to deduct his year's rent and payment to a cleaning woman; Brody v. Commissioner, 8 T.C.M. 288. A second taxpayer and his wife took an extended holiday in the sunshine as an aftermath of ulcers and pneumonia, Keller v. Commissioner, 8 T C M. 685 Dobkin v Commissioner, 15 T.C. 886, concerned a heart patient who took annual Florida vacations. Havey v. Commissioner, 12 T.C. 409, involved another heart patient who returned to old vacation haunts in New Jersey and Arizona as late as two years after the attack. All these five taxpayers were halted by the same stumbling block None of them could show a direct relation between (1) the heart condition or the ulcers and (2) the Florida sunshine. The inference was unavoidable that the patient enjoyed a relief from the cold winds of winter for his general well-being, in some cases, he might very well have made the trip anyway according to his long-established vacation practices. The Commissioner and the Tax Court, on the other hand, have sanctioned deductions of funds paid for southern exposures in cases where the patients went South for relief from asthma, hay fever, or respiratory infections, i.e., where a direct relation was proved between the southern climate and treatment of the disease. Stringham v Commissioner, 12 T C 580, affirmed 6 Cir., 183 F.2d 579.

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ing food, clothing, frigidaires, electric dish-washers—in short, allowances as medical expenses for everything "helpful to a convalescent housewife or to one who is nervous or weak from past illness." I, for one, trust the Commissioner to make short shrift of most such claims.[4] The tests should be. Would the taxpayer, considering his income and his living standard, normally spend money in this way regardless of illness? Has he enjoyed such luxuries or services in the past? Did a competent physician prescribe this specific expense as an indispensable part of the treatment? Has the taxpayer followed the physician's advice in the most economical way possible? Are the so-called medical expenses over and above what the patient would have to pay anyway for his living expenses, *i.e.*, room, board, etc.? Is the treatment closely geared to a particular condition and not just to the patient's general good health or well-being?

My colleagues are particularly worried about family expenses, traditionally non-deductible, passing as medical expenses. They would classify the children's schooling here as a family expense, because, they say, it resulted from the loss of the wife's services. I think they are mistaken. The Tax Court specifically found that the children were sent away so they would not bother the wife, and not because there was no one to take care of them. Ochs' expenditures fit into the Congressional test for medical deductions because he was compelled to go to the expense of putting the children away primarily for the benefit of his sick wife. Expenses incurred solely because of the loss of the patient's services and not as a part of his cure are a different thing altogether. *Wendell* v. *Commissioner*, 12 T.C. 161, for instance, disallowed a deduction for the salary of a nurse engaged in caring for a healthy infant whose mother had died in childbirth. The case turned on the simple fact that, where there is no patient, there can be no deduction.

Thus, even here, expense attributed solely to the education, at least of the older child, should not be included as a medical expense. See *Stringham* v. *Commissioner*, *supra*. Nor should care of the children during that part of the day when the mother would be away, during the period while she was working part-time. *Smith* v. *Commissioner*, 40 B.T.A. 1038, affirmed 2 Cir., 113 F.2d 114. The same goes for any period when the older child would be away at public school during the day. In so far as the costs of this private schooling are thus allocable, I would limit the deductible expense to the care of the children at the times when they would otherwise be around the mother. If my views prevailed, this might require a remand to the Tax Court for such allocation.

Line-drawing may be difficult here as everywhere, but that is what courts are for. See *Lavery* v *Purssell*, 399 Ch. D. 508, 517: ". . . courts of justice ought not to be puzzled by such old scholastic questions as to where a horse's tail begins and where it ceases You are obliged to say, this is a horse's tail at some time."

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1. There has been a spate of similar borderline cases. The two most common issues are the deductibility of (a) expenses that partake of both ordinary living expenses and

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medical treatment, like vacations, additional servants, etc. and (b) expenses of other members of the family, as in the *Ochs* case. See Hodgkin, "If You Eat to Stay Healthy—Here's New Light on the Medical Deduction," 30 *Taxes* 206 (1952).

The deductibility of travel expenses is clarified by § 213(e)(1)(B) of the 1954 Code. The Senate Report (pp. 219-220) explains this new provision as follows:

> The deduction permitted for "transportation primarily for and essential to medical care" clarifies existing law in that it specifically excludes deduction of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments and to escape unfavorable climatic conditions which have proven injurious to the health of the taxpayer, and the travel is prescribed for reasons other than the general improvement of a patient's health, the cost of the patient's transportation to Florida would be deductible but not his living expenses while there. However, if a doctor prescribed an appendectomy and the taxpayer chose to go to Florida for the operation not even his transportation costs would be deductible. The subsection is not intended otherwise to change the existing definitions of medical care, to deny the cost of ordinary ambulance transportation nor to deny the cost of food or lodging provided as part of a hospital bill.

The 1954 Code also adopted a limitation with respect to the cost of medicine and drugs; these expenses may now be "taken into account" only to the extent that they exceed 1 per cent of adjusted gross income. (The amount taken into account, along with other medical expenses, is still subject to the 3 per cent limit (which before 1954 was 5 per cent) referred to in the next paragraph.) The Senate Report (p. 219) states:

> While some question has been raised under present law by taxpayers as to whether the expenditures for toiletries and sundry items may be taken into account this provision makes it clear that expenditures for medicine and drugs (whether or not requiring a prescription) are taken into account but expenditures for toiletries and sundries are not.

2. To be deductible, the expenses must be "extraordinary"—*i.e.*, in excess of 3 per cent of "adjusted gross income." (For this term, see Chapter 3, Sec. C.) If the taxpayer or his spouse is 65 years of age, however, the 3 per cent limitation is lifted for their own medical expenses, though it remains applicable to the medical expenses paid by such a taxpayer for dependents At the same time, the expenses must not be too extraordinary: the deduction may not exceed $2500 (a taxpayer without dependents), $10,000 (husband and wife filing a joint return or a head of a family), or $5,000 (others). These limitations may be avoided to a certain extent by postponing or accelerating payments. The point is illustrated by this story from *The New Yorker* (April 4, 1953, p. 26):

> During the third week of December, a baby girl was delivered at the New York Hospital—everything O.K. The father had a chat with the officiating obstetrician and emerged from his office looking annoyed. He visited his wife and child daily during the prescribed week of confinement, but then, instead of picking them up the next day, he failed to show. The interne asked the obstetrician if there were any complications, he said no. A couple more days passed, and no husband The wife, pressed by the staff for an explanation, looked glum, smoked, and offered none. Finally, on New Year's Day—five days after his family should have been home—he appeared, beaming, settled the hospital bill, and whisked his wife and child to the elevator. The nurse who was holding the baby ventured to ask him what was going on. "Young woman," he said, "I was told when the baby was born that the obstetrician's bill couldn't possibly be made up and presented for payment until sometime in January. I was damned if I'd split the medical deductions on my income tax between two years, so I waited until 1953 to take care of the hospital charges." And off he and his little family went, into a deductible taxi. (Reprinted by permission. Copyrighted 1953, *The New Yorker* Magazine, Inc.)

Was the taxi deductible?

3. Note that expenses may be deducted only if "not compensated for by insurance or otherwise." If *A* pays medical expenses in 1954, and expects to be fully reimbursed under a health or accident policy in 1955, may he deduct the expenses in 1954? If he does not, or may not, may he deduct them in 1955 if his expectation of payment is defeated?

4. See also § 104, exempting amounts received as compensation for personal injuries or sickness "except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 . . . for any prior taxable year." *Supra*, p. 143. Suppose B is injured in an automobile accident, incurring medical expenses of $1000 in 1952, of which he deducts $600, and in 1955 recovers $15,000 for his expenses, pain, and suffering. What, if anything, is taxable in 1955? Would the tax status of the recovery be altered if *B*, though entitled to a deduction of $600 under § 23(x) in 1952, had had other deductions and credits exceeding his net income and either (a) claimed the medical deduction or (b) did not claim it?

Section 105 (exempting certain amounts received under employee accident and health plans) also contains cross-references to § 213. Amounts received by the employee under § 105(c) (payments for permenant injury) or under § 105(d) (compensation during sick leave) are not to be treated as compensation for medical expenses; the employee may exclude these amounts and also may deduct his medical expenses under § 213. Where the employee is reimbursed for his medical expenses, Sections 105(a) and 105(b) operate to prevent double deductions: if the expenses were previously deducted, the reimbursement is includible in gross income; otherwise, the reimbursement is excluded from gross income, but the expenses cannot be deducted because they have been "compensated for by insurance or otherwise."

5. On rare occasions, medical expenses have been held deductible under § 162 as "ordinary and necessary expenses" of carrying on the taxpayer's occupation. Thus, Reginald Denny was allowed to deduct the cost of replacing teeth knocked out in the course of making a prize fight movie, *Denny* v. *Commissioner*, 33 B.T.A. 738 (1935). But Madge Evans' tonsillectomy was held not a deductible business expense. *Evans* v. *Commissioner*, 1939 B.T.A. ¶ 39,101 P-H Memo. Here the court said. "The operation was performed for the purpose of correcting petitioner's susceptibility to colds. There has been no showing that these colds resulted from petitioner's business activities." No doubt many individuals could prove that various ailments resulted from their occupation. Would the expenses then be deductible? What of a lawyer's hypertension? To the extent that medical expenses are deductible under § 162, they are not subject to the 3 per cent and $2500-5000-10,000 limitations.

6. On the economic effectiveness of the medical deduction, see Jensen, "Medical Expenditures and Medical Deduction Plans," 60 *J. Pol. Econ.* 503 (1952).

2. *Charitable Contributions*

Note: Sections 23(o) and 120 of the 1939 Code, relating to charitable contributions by individuals, and § 23(q), relating to contributions by corporations, have been consolidated, and somewhat modified, by § 170 of the 1954 Code.

See Regs. 118, Sec. 39.23(o)-1.

HAVEMEYER v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1938

98 F.2d 706

Before L. Hand, Swan, and Chase, Circuit Judges.

Chase, Circuit Judge. . . .

The question presented is whether the petitioner was entitled, under the pro-

visions of § 23(n)(2) of the Revenue Act of 1932 [§ 22(o), '39 Code, § 170, '54 Code], to a deduction for contributions he made in that year to an unincorporated association known as the United Special Aid Association. The Commissioner decided that he was not entitled to the deduction and determined the deficiency by adding the amount claimed to his gross income. The Board of Tax Appeals upheld the action of the Commissioner.

The United Special Aid Association was formed in 1918 by the petitioner, members of his family, and a close business associate. It was organized in compliance with the law regulating the formation of unincorporated associations and, to quote from its articles of association, "in order to unify and co-ordinate the charitable activities of themselves and other persons who may hereafter become members of this Association" and "to be operated exclusively for charitable purposes." Its members comprised the original signers of the articles of association to whom might be added such other persons as might be elected by a majority vote of the Board of Managers. A member was bound to pay annual dues of five dollars and was otherwise free to contribute or not as desired. The Board of Managers consisted of five persons to be elected at each annual meeting of the Association since its formation. Under a provision making three a quorum of the Board of Managers, the petitioner and two others have been in actual charge of its affairs. From the time it was formed and up to the year 1932, the Association had received $47,975.87 and had distributed the sum of $46,992.23. In 1932 it had nine members who contributed $3,618.85 of which the petitioner gave $2,257.60 That is the deduction he claimed which was disallowed. During 1932, the Association assisted nine indigent and deserving individuals. None of them were related to any of the members by blood or marriage and no member was under any legal or equitable obligation to contribute to the support of any of the beneficiaries who, though it was customary for a contributor to suggest the person to be aided, were all designated by the Board of Managers. They were mainly, though not entirely, old family retainers and all were needy and worthy.

The constitution of the Association provided in part that.

> The purpose of this Association shall be to collect funds and therefrom to give relief to such indigent and deserving persons as the Board of Managers may from time to time consider to be in especial need of the bounty of the Association. No payment shall be made from the funds of the Association to or for the use of any officer, manager, or member of the Association.

The provisions of the constitution have at all times been carried out in good faith and the books and records of the Association have always been kept without expense to it. The meetings of its Board of Managers have been held in the offices of Havemeyer & Elder, Inc., which is a corporation of which the members of the board who have been in active charge are officers.

The above mentioned statute relied upon in support of the deduction claimed, Sec. 23 (n) (2) of the 1932 Act, 26 U.S.C.A. § 23 note, provides that in computing the net income of an individual there shall be allowed as deductions the contributions or gifts made within the taxable year to or for the use of;

> a corporation, or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for

the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, . . .

No claim is made that the contribution made by the petitioner to the Association exceeded the proportion of his income deductible under the above statute if made to a charitable organization therein designated but the theory on which the deduction was disallowed and its disallowance upheld by the Board was that this Association served but as a means for facilitating the bestowal of private bounties and could not be classed as a charitable association within the meaning of the statute.

It is true that the beneficiaries who were actually designated by the Board of Managers were all personally known to one or more members of the Association and were people who might perhaps have been given aid by one or more of them had the Association not been in existence but that does not change the character of the Association itself. That was as extensive in charitable scope within the ranks of the indigent and deserving public as its means and the discretion of its Board of Managers might make it. Its activities were exclusively charitable within the statutory meaning of that term. *Harrison* v. *Barker Annuity Fund*, 7 Cir., 90 F.2d 286, 289; *Gimbel* v. *Commissioner*, 3 Cir., 54 F.2d 780; *Bok* v. *McCaughn*, 3 Cir., 42 F.2d 616. And they were all of the kind it was organized to conduct as shown by the articles of association and within the limitations of its constitution. Having been organized to perform exclusively acts of charity and having performed such acts and no others, this Association in form and fact was a charitable association of the kind named in Sec. 23 (n) (2) of the Revenue Act of 1932, 26 U.S.C.A. § 23 note. It had no net earnings so far as appears and certainly no part of them, if it had any, inured to the benefit of any private shareholder or individual having a personal and private interest in the activities of the Association. See, T.R. 77; Art. 527. Consequently gifts made by individuals to the Association within the taxable year were deductible in computing the net income of the petitioner.

Reversed.

L. HAND, Circuit Judge (*dissenting*).

It seems to me that this was not the kind of charitable association that the statute had in mind. Practically, it was a pool of the charitable contributions of the Havemeyer family, distributed by two of them—the petitioner being one—helped by a business associate. True, it does not expressly appear that any member of the family could insist upon his contributions going to an especial person, and in law no doubt he could not; but I cannot believe that practically this was not the case. I am not altogether clear that a taxpayer might deduct a contribution even to a standard charitable association, if in advance he were to exact an agreement that it should be devoted to a particular person. If the association asks him for special funds, of course, he may; but I am speaking of a case where he uses it merely as a conduit. However that may be, it was an inference which the Board might make that here this association was nothing else but a conduit. While the family was to manage the pot through three managers, of whom the petitioner was only one, I cannot take seriously the possibility that, at least as to his own contributions, his two associates would have attempted to gainsay any distribution he wished. It is significant for example that his and his wife's distri-

butions for 1932 just used up his contributions. As to him anyway and to the extent of the deductions now claimed, I think this association was pro hac vice merely a conduit. In general I believe that we ought not to countenance avoidance of taxes by the perpetual device of a corporation, organized only in form, and not in reality, for the purposes intended by a statute.

Note

1. What if the beneficiaries had been needy members of the donor's family? Would a contribution to a university be deductible if given on the understanding that a particular student would receive a scholarship? See *Thomason* v. *Commissioner*, 2 T.C. 441 (1943), *Crellin* v. *Commissioner*, 46 B.T.A. 1152 (1942).

2. Note that contributions are not deductible if the organization abuses its status by engaging in various "prohibited transactions." Ch. 7, Sec. C.; Brown, "The New Restrictions on Charitable Exemptions and Deductions for Federal Income Tax Purposes," 13 *U. of Pitt. L. Rev.* 623 (1952). Section 11 of the Internal Security Act of 1950 similarly disqualifies "communist-action" organizations, a policy which the Treasury Department had previously followed as to organizations on the Attorney General's list of subversive organizations. Treasury Department, Press Service, Release No. S-613 (2/4/48). *Cf. Joint Anti-Fascist Refugee Committee* v. *McGrath*, 341 U.S. 123 (1951).

3. For many years, in the case of an individual taxpayer, the deduction could not exceed 15 per cent of the taxpayer's "adjusted gross income" (Ch. 3, Sec. C); in 1952, the ceiling was lifted to 20 per cent and the 1954 Code permits contributions up to 30 per cent of adjusted gross income if at least ⅓ of the contributions are to churches, hospitals, and educational institutions If the taxpayer is *really* generous, however, the limit is not applicable. Section 170(b)(1)(C). In the case of corporations, the limit is 5 per cent, but (as a result of a 1954 change) if a corporation exceeds the limit, it may carry over the excess and use it as a deduction in the next two years if its contributions then fall short of the allowable 5 per cent.

4. See Paulsen, "Preferment of Religious Institutions in Tax and Labor Legislation," 14 *Law & Contemp. Prob.* 144 (1949).

ESTATE OF HARRINGTON v. COMMISSIONER

Tax Court of the U. S., 1943
1943 P-H T.C. Memo. Dec., Para. 43, 369

HILL, Judge: The sole issue of this proceeding is whether or not petitioner received either capital gain or ordinary income by the transfer of stock in satisfaction of debts owed to charities. These debts were included and allowed as liabilities in the estate tax return. The facts show that petitioner discharged a debt of $5,000 owing to the Community Corporation with 25 shares of Bank stock. These shares were owned by decedent at the time of his death and their fair market value as of the date of his death [Feb. 27, 1932] was $100 each....

Petitioner discharged its obligation of $5,000 to Community Corporation by delivering to it [on Oct. 20, 1938] 25 shares of Bank stock which decedent owned at his death.* This stock had a fair market value of $100 per share at the death of decedent which was its basis in the hands of petitioner for gain or loss. Consequently, in the transaction with Community Corporation, petitioner realized a capital gain of $2,500.

*Although the 25 shares were delivered in full settlement of the unpaid pledge of $5,000, the court found that the shares were worth only $110 per share when delivered. [Ed.]

Note

1. For many years the Regulations have provided that if the contribution is made in property, its fair market value may be deducted, Regs. 118, Sec. 39.23(o)-1(g). It has always been assumed that, absent a pledge of a specific amount of money, any appreciation in the donated property goes untaxed. The taxpayer is therefore well advised to donate appreciated property. (If he holds depreciated property, it can be sold and a deductible loss obtained; thereafter, the proceeds can be donated.) Is this a defensible way to reward charitable contributions? Does this non-recognition of appreciation on property donated to charity extend to all types of property? See the articles by Griswold, Bittker, and Roehner, cited *supra*, p. 83; *White* v. *Brodrick*, 104 F. Supp. 213 (D. Kan. 1952); *Campbell* v. *Prothro*, 209 F.2d 311 (5th Cir. 1954). In *Truncale* v. *Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), the plaintiff sought to recover a "profit" under § 16(b) of the Securities Exchange Act of 1934, on the theory that a corporate insider who had bought securities at one price and donated them to charity at a time when their value exceeded his cost had realized a "profit," since the value at the time of the gift could be deducted for tax purposes. The Court rejected the argument, saying "The tax laws would seem to have absolutely nothing to do with the question."

2. The Bureau has ruled that the rental value of property may not be deducted by a taxpayer who allows a charitable organization to occupy it. The reason given was that § 170(a)(1) requires a "payment." "Such an arrangement does not constitute a gift of property. It is merely the granting of a privilege for which no charge is made." I.T. 3918, 1948-2 C.B. 33. Did the taxpayer realize income? The Bureau has also ruled that the fair market value of blood contributed to a charitable institution is not deductible because furnishing blood "is analogous to the rendering of a personal service by the donor rather than a contribution of 'property.'" Rev. Rul. 162, 53-2 C.B. 127. A related issue is the treatment of the performance of services by the taxpayer for the charity's benefit. See *infra*, Chapter 4, Sec. C(1).

3. Alimony

Note: Sections 23(u) and 22(k) of the 1939 Code, permitting the deduction of certain alimony and separate maintenance payments are re-enacted in somewhat broadened form by §§ 215 and 71 of the 1954 Code.

Section 171 of the 1939 Code, relating to alimony trusts, is re-enacted, with corresponding changes, by § 682 of the 1954 Code. See Regs. 118, Sec. 39.23(u)-1 and 22(k)-1.

MAHANA v. UNITED STATES

U. S. Court of Claims, 1950

88 F. Supp. 285, Cert. den. 339 U.S. 978, reh. den. 340 U.S. 847 (1950)

Before JONES, Chief Judge, and MADDEN, HOWELL, WHITAKER and LITTLETON, JJ.

MADDEN, Judge.

The plaintiff sues to recover income taxes paid by her for the years 1943, 1944 and 1945. She filed timely claims for refund which were denied by the Commissioner of Internal Revenue. The money received by her, the taxability of which receipt she contests, came to her, partly directly, and partly through payments by a trustee or depositary, from her husband whom she had divorced.

The plaintiff and George S. Mahana were married in 1893. They separated in

1922. In 1923 she brought an action in New York, where they both resided, for a legal separation and separate maintenance. While this suit was pending, the spouses on November 12, 1923, made a written agreement that the husband would transfer certain named securities to the Guaranty Trust Company of New York, in trust to pay the income to the plaintiff during her lifetime "by way of alimony and in lieu thereof and for her separate maintenance and support." If the income from the securities did not amount to $17,500 per year, the husband would make up the deficit by payments to the trustee for transmission to the plaintiff. If there was an excess of income, it was to be paid to the husband. If the plaintiff's mother survived her, she was to be paid $6,000 per year for life. Upon the death of the survivor of the plaintiff and her mother, the trust was to terminate and the securities were to be returned to the husband. If the securities did not in any one year yield at least $15,000, the husband agreed to add sufficient securities to bring the yield up to $17,500. The parties mutually released to each other all interest in the other's property and in any rights growing out of their marital relation. The agreement provided that it should in no wise prejudice any right which either party might have to institute divorce proceedings for misconduct theretofore committed, and that the payments to be made under the agreement were to be in no way affected by any decree of divorce, or by any subsequent marriage of either of the parties to a third party.

On December 1, 1923, the plaintiff signed a complaint in a New York court asking for an absolute divorce on the ground of her husband's adultery. An interlocutory decree was granted on March 8, 1924, which became final on November 6, 1924. On November 26, 1924, the former husband, George Mahana, transferred his residuary interest in the trust which he had set up for the plaintiff, in irrevocable trust for his second wife and his infant child by her.

In 1929 disputes arose between the plaintiff and her former husband as to which one should pay the state and federal income tax on the payments which the plaintiff was receiving under the 1923 agreement. The plaintiff instituted a suit in a New York court to construe and enforce the agreement of 1923 according to what she claimed to have been the intent of the parties. Her complaint alleged that her husband was to have paid the income taxes upon the payments to her to the extent that they would have been payable "if said $17,500 would have been her sole income." Her complaint raised other questions concerning the trust. This suit was settled by an agreement of June 28, 1933. By this agreement, the former husband agreed to pay the plaintiff the amounts by which her state and federal income taxes were increased by reason of her receipt of the $17,500 pursuant to the 1923 agreement. In connection with the new agreement, he deposited additional securities with the trustee, but he did not put them into the trust created in 1923. The income from them was to be used to supplement the income from the securities in the 1923 trust, if necessary, but he was to have complete power, so long as he was not in default under his agreement, to order the securities so deposited to be sold or exchanged.

The plaintiff paid federal income taxes for the year 1924 upon her income under the agreement, but these taxes were refunded to her by the Government, upon her claim for refund. She paid no such taxes from 1932 to 1942. The record does not show what happened between 1924 and 1932. In the Revenue Act of 1942, 56 Stat. 816, Section 120, added to the then existing law, Sections 22(k), 23(u),

and 171(a) of the Internal Revenue Code, 26 U.S.C.A. §§ 22(k), 23(u), 171(a). Section 22(k) provides:

In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includable in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includable in the gross income of such husband. . . .

Section 23(u) authorized a husband to deduct from his taxable income the payments made taxable to the wife by Section 22(k). Section 171(a) provided:

There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance the amount of the income of any trust which such wife is entitled to receive and which except for the provisions of this section, would be includable in the gross income of her husband, and such amount shall not, despite section 166, section 167, or any other provision of this chapter, be includable in the gross income of such husband. . .

As shown by our findings 12, 13, and 14, the $17,500 received by the plaintiff in each of the years in question, 1943, 1944, and 1945, consisted of (1) money paid by the trust company out of the income of securities held by it under the 1923 agreement; (2) money similarly paid out of the income of securities held by it under the 1933 agreement; (3) money paid by George Mahana to the trust company to make up the deficit of income from the first two sources, which money was then paid by the trust company to the plaintiff. In addition, in each of the years George Mahana paid directly to the plaintiff the amounts by which the plaintiff's income taxes had been increased by her receipt of the $17,500. Since some of these payments were made directly by the former husband, and some were made from a trust created by him for that purpose, both Sections 22(k) and 171(a) are involved.

The plaintiff's first contention is that the legislation referred to, imposing an income tax on alimony, is unconstitutional. She says that it is not income; therefore the Sixteenth Amendment does not authorize its taxation. The argument is, at first, surprising. A large sum of money comes into the plaintiff's hands. One wonders why it is not "income" in the sense of the Sixteenth Amendment. It is income to spend, to live on, to save. Is it not also income to tax, if Congress sees fit, as it has, to tax it? But there is something to be said for the plaintiff's contention. In the case of *Gould* v. *Gould*, 245 U.S. 151, 38 S. Ct. 53, 62 L. Ed. 211, the court held that alimony paid to a divorced wife was not taxable to her as income. The legislation then in force was the Income Tax Act of 1913. It did not expressly either include or exclude alimony from its definition of what income should be taxed. The court used language which indicated that it thought that alimony was not income. The court did not purport to be deciding a constitutional question, but only a question of the interpretation of the Income Tax Act of 1913. It would have been hard to believe that Congress intended to tax the receipt of alimony by the divorced wife, when the law had already taxed the husband upon his receipt of the income from which he paid the alimony, except in the infrequent case when alimony was paid out of the husband's capital.

The plaintiff points to cases such as *Douglas* v. *Willcutts*, 296 U.S. 1, 56 S. Ct. 59, 80 L. Ed. 3, 101 A.L.R. 391, and *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, in which the Supreme Court has said that Congress, in the various revenue acts, has manifested its intention to use to its fullest extent the power granted it by the Sixteenth Amendment. If we take these expressions literally, then *Gould* v. *Gould*, *supra*, would have to be regarded as a decision that alimony could not be taxed because it was not income in the sense of the Sixteenth Amendment. But we think that even the Supreme Court should not be taken so literally when the consequence would be to nullify an act of Congress, the intention of which is clear. The Supreme Court has also said that the meaning of the word "income" in the Sixteenth Amendment and in the acts of Congress pursuant to the amendment, is that given it in common speech and every-day usage. *Old Colony Railway Co.* v. *Commissioner*, 284 U.S. 552, 52 S. Ct. 211, 76 L. Ed. 484; *United States* v. *American Trucking Association*, 310 U.S. 534, 60 S. Ct. 1059, 84 L. Ed. 1345. In every-day usage the plaintiff, receiving large sums of money currently from a man who ceased to be her husband more than twenty years ago, would be regarded as having an income.

We come then to the question whether the statutes, properly interpreted, tax the plaintiff's income. The plaintiff concedes that, so far as concerns the money received by her as the yield of the securities placed in trust under the 1923 agreement, Section 171(a) is applicable, if it is constitutional. We have quoted the section, and it requires only that there be a divorce, a trust, and the receipt from the trust of income which would have been taxable to the husband if it had not been made taxable to the wife by the section. As the plaintiff properly concedes, these conditions are fulfilled as to the yield of the 1923 trust. We think they are fulfilled also as to the yield from the additional securities deposited with the trustee in 1933, to supplement the income of those previously deposited. The plaintiff says that they were not placed in trust, but only "deposited." But they were deposited "pursuant to the agreement dated November 12, 1923, . . . to be held, sold, exchanged or otherwise disposed of by you, and in case of sale, the proceeds thereof invested. . . ." The trust company was directed to pay the income from the securities to the plaintiff, if necessary to make up the agreed $17,500. The deposit of these securities was a deposit in trust. The apparent reason why they were not added to the 1923 trust was that, in the meantime, the plaintiff's former husband had conveyed his residuary interest in that trust to his second wife and his infant child by her, and he did not want the additional securities to be covered by that conveyance. The new securities were in a different trust, but it was a trust to pay alimony and was covered by Section 171(a).

As to the money which the former husband paid to the trustee to make up the deficit left when the two trusts did not yield $17,500, we think that although this money came to the plaintiff from the trustee, it was not "the income of any trust" within the meaning of Section 171(a). The trustee was a mere intermediary who accepted a deposit and paid out a similar amount to the plaintiff, not as income of a trust but merely pursuant to the agreement to perform this service. If, then, these payments were taxable to the plaintiff, it was because they were covered by Section 22(k) which we have quoted above. The plaintiff urges several reasons why they should not be regarded as covered by that section. The section applies to "periodic payments (whether or not made at regular intervals)." Although

this language is somewhat self-contradictory, we think that it is complied with when the payments are agreed to be made and are made whenever specified external or objective conditions occur. Here the payments were to be made whenever the income of the trust was less than $17,500.

Section 22(k) requires that the payments, to be taxable, must be made:

> . . . in discharge of, a legal obligation, which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation . . . .

The plaintiff says that the written instrument by which her then husband agreed to make the payments here in question was not "incident to such divorce." We think it was so incident. The plaintiff had pending a suit for legal separation and separate maintenance at the time of the agreement. The agreement said that it was for her separate maintenance and support, that it was not to be affected by any decree of divorce obtained by her, and that it was not to prejudice the right of either party to seek a divorce for misconduct which antedated the agreement. Thirteen days after the agreement was executed, the plaintiff signed her complaint asking for a decree of divorce for her husband's adultery. We have no doubt, from the timing and circumstances of the agreement, that it was the usual settlement out of court of the property rights of the parties when a divorce is contemplated. Both the plaintiff and her former husband testified in this case and neither denied what the circumstances indicate to have been the fact. The payments made by the former husband to make up the deficit were, then, periodic payments, made pursuant to an agreement incident to the parties' divorce. The payments were taxable income to the plaintiff, under the provisions of Section 22(k).

The question remains as to whether the former husband's payments to the plaintiff by way of reimbursement to her of the amounts which she was obliged to pay as income tax on her alimony, after the enactment in 1942 of Section 22(k), were also taxable to her under Section 22(k). The plaintiff contends that they were not, because they were paid pursuant to the 1933 agreement, which was made nine years after the divorce and was not, the plaintiff says, "incident to such divorce" in the sense of the statute. We think that the 1933 agreement was incident to the divorce. We have held above that the 1923 agreement was incident to the divorce. The 1933 agreement was, as we have seen, made in settlement of a suit by the plaintiff for the construction and enforcement of the 1923 agreement. She contended, in that suit, that her former husband was, under the 1923 agreement, obligated to reimburse her for income taxes paid "as if said $17,500 would have been her sole income." In the 1933 agreement, her former husband promised to do more than that; he promised to reimburse her by the amount which her income taxes were actually increased by her receipt of the $17,500. For this concession, he received concessions from her which made him willing to enter into the 1933 agreement. But the whole agreement was made to clarify the 1923 agreement, so that the disputes as to its meaning which had, in 1933, been going on for some years, could be avoided. The plaintiff had no rights against her former husband in 1933 except those that were given her by the 1923 agreement. The rights which she got under the 1933 agreement were, with mutually satisfactory additions and subtractions, those to which she was entitled under the 1923 agreement. We think, therefore, that the reimbursements to her of her

income taxes paid by her on her alimony were made pursuant to a written instrument which was incident to her divorce.

The Government urges, as an additional reason for reaching the same conclusion, that we interpret the language of Section 22(k) as meaning that the written instrument referred to need only be incident to the fact that there had been a divorce, and not to the decree of divorce The Tax Court, in *Dauwalter* v. *Commissioner*, 9 T.C. 580, has rejected this interpretation. Compare *Commissioner* v. *Murray*, 2 Cir., 174 F.2d 816. See also *Cox* v. *Commissioner*, 3 Cir., 176 F.2d 226, for a treatment of this question, and of the history and purpose of the 1942 legislation relating to the taxation of alimony. In view of our conclusion that the 1933 agreement, through its connection with the 1923 agreement, was incident to the decree of divorce, we do not pass upon this contention of the Government as to the interpretation of Section 22(k).

The plaintiff's petition will be dismissed. It is so ordered.

JONES, Chief Judge, and HOWELL, WHITAKER, and LITTLEJOHN, JJ., concur.

Note

1. As the foregoing case indicates, prior to the statutory revision of 1942, *Gould* v. *Gould*, 245 U.S. 151 (1917), had held that alimony payments were not taxable to the wife. Nor were the payments deductible by the husband, since there was no statutory authorization for a deduction. If the husband transferred property in trust, the income of which went for alimony, that income would nevertheless be taxed to him because applied to pay his debts. The husband's only escape was to make a lump sum transfer of property to discharge his obligation of support once and for all; if under local law the husband's support obligation could be terminated in this manner, the income from the property would thereafter be taxed to the ex-wife. *Helvering* v *Fuller*, 310 U.S. 69(1940). If local law, a want of capital, the ex-wife's resistance, or other reasons made such a termination of his obligation of support impossible, the husband under the impact of rising tax rates might be left with little or no income of his own, especially if his misalliances had been lavish in number or in cost. These facts led to the 1942 revision.

2. Under § 215, the husband may deduct alimony payments only when they are taxed to the wife under § 71. Section 71's technical requirements—which thus determine when the wife is taxed on, and the husband may deduct, alimony—have engendered a surprising volume of litigation. See Rudick, "Marriage, Divorce, and Taxes," 2 *Tax L. Rev.* 123 (1947), Note, 61 *Yale L.J.* 1198 (1952). The following phrases in § 71 are especially noteworthy:

(a) "A decree of divorce or of separate maintenance." This requirement was adopted to prevent collusive separation agreements for the purpose of splitting income between husband and wife. It may have been necessary in 1942, but since enactment of the Revenue Act of 1948—as will be seen in a few pages—married couples may split their income for tax purposes by filing a joint return. Although couples separated by agreement are permitted to file joint returns, it may not be feasible for them to do so, since both must sign the return and assume liability for payment of the total tax. Until 1954, a couple that was separated, even though under a *bona fide* separation agreement, could not take advantage of the alimony deduction. The 1954 Code, by § 71(a)(2), allows payments under a "written separation agreement" to qualify, even though there was no judicial decree of separation or divorce; but because the pre-1954 law may have been taken into account in fixing support payments under such agreements, only agreements executed after the 1954 Code was enacted are covered. Section 71(a)(3) extends the same principle, with the same time limit, to support payments under court order, even though there is no decree of divorce or separate maintenance or written separation agreement.

The requirement of a "decree" of divorce or of separate maintenance was held to be satisfied by a Florida divorce, even though the divorce had been held invalid in the state of marital domicile. *Feinberg* v. *Commissioner*, 198 F.2d 260 (3d Cir. 1952).

(b) "A written instrument incident to such divorce or separation." If the husband's obligation is imposed by a decree, the payments will qualify. They will also qualify if an agreement between the spouses is incorporated in the decree. But if the agreement is made before the divorce or legal separation and not mentioned in the decree, or if it is made after the decree is rendered, the proper treatment of the payments is more debatable. As the last paragraph of the *Mahana* case indicates, the Treasury itself has taken inconsistent positions, depending upon whether the taxpayer was husband or wife. In *Lerner* v. *Commissioner*, 195 F.2d 296 (2d Cir. 1952), the Court held that payments under an agreement qualified though the decree did not refer to the agreement and the obligation imposed by the agreement was not dependent upon the obtaining of a divorce. See also *Newton* v. *Pedrick*, 212 F.2d 357 (2d Cir. 1954).

(c) "Periodic payments (whether or not made at regular intervals)." A lump sum settlement will not qualify for the deduction, even though paid in installments, unless it is to be paid over a period longer than ten years. Even then, an installment payment may be deducted only to the extent that it does not exceed 10 per cent of the principal sum. Why these restrictions on the deduction of lump sum settlements? It has been held that a payment of alimony arrears is taxable to the ex-wife, and deductible by the husband, in the year of payment, notwithstanding the effect of telescoping into a single year income that should have been received in a number of years. Thus in *Estate of Narischkine* v *Commissioner*, 14 T.C. 1128 (1950), aff'd. p.c. 189 F.2d 257 (2d Cir. 1951), about $70,000 that should have been paid in equal amounts over a period of nine years was taxed in the year it was paid. See also *Holahan* v. *Commissioner*, 21 T.C. No. 57 (1954).

(d) Amounts "payable for the support of minor children" are not deductible.

3. The alimony sections are a good example of how an entire area of legal practice may become tax-dominated.* The negotiations for alimony, especially in the higher brackets, will be governed in an important degree by the tax status of each party, and the agreement itself must be drafted with § 71's technical requirements in sight.

4. The advent of § 71 has led to some troublesome problems (a) of modifying pre-1942 divorce decrees to increase the wife's allowance in view of this unexpected expense, and (b) of interpreting old agreements to determine whether the husband promised the wife a sum net of taxes. As the *Mahana* case demonstrates, if the husband is to pay a stated sum annually, plus the ex-wife's tax thereon, the latter amount, as well as the former, will be alimony, deductible by the husband and taxable to the wife. See *Old Colony Trust Co.* v. *Commissioner*, 279 U.S 716 (1929). Under the 1933 agreement, would the husband have to pay the tax caused by the ex-wife's receipt of $17,500 no matter how much other income she received? Note that if the agreement or decree is construed to require the husband to discharge the wife's tax on the amount he paid to discharge her tax on the primary payment, there will be one more deduction for the husband and item of income for the wife. And so on. The same problem can arise, and the same principle is applicable, when an employer agrees to pay his employee's income taxes, when a lessor of property agrees to pay the lessee's taxes on the rent, etc. The Bureau has announced that it will not concern itself with the mechanics by which the parties settle such obligations *inter sese; i.e.*, it will accept their determination of the number of rounds for which the computation of reimbursement is made. Mim. 6779, 52-1 C.B. 8, as modified by IR-Mim. 51, 52-2 C.B. 65. See Brown, "Shifting the Burden of Income Taxes by Contract," 96 *U. of Pa. L. Rev.* 822 (1948); Kades, "Phantom Income Net Leases and the Clark Case," 5 *Syracuse L Rev.* 18 (1953). Section 110, new in the 1954 Code, alters the rule as to pre-1954 net leases.

* Calling attention to the fact that the husband can deduct permanent alimony but not temporary alimony, the Appellate Division, First Department, of the New York Supreme Court has said: "This difference should be kept in mind in fixing temporary and permanent alimony. The tax factor affords further reason for speeding the trial" Yudell v Yudell, 126 N.Y S 2d 163 (1953). Is temporary alimony deductible under § 71(a)(3) of the 1954 Code?

4. *Interest*

Note: Section 23(b) of the 1939 Code, permitting interest to be deducted, is re-enacted by § 163(a) of the 1954 Code.
Section 163(b) of the 1954 Code is new.
See Regs. 118, Sec. 39.23(b)-1.

HOLDEN v. COMMISSIONER

Board of Tax Appeals, 1933
27 B.T.A. 530

TRAMMELL: The sole issue in this case is whether the petitioner is entitled to deduct from his gross income for the taxable years certain amounts paid by him during said years on account of interest and taxes accruing on the cooperative apartment building in which the petitioner had leased a residential apartment. . . .

The facts were stipulated by the parties, and the issue of law presented may be resolved into the question of whether or not the payments made by the petitioner were so made on account of his liability for interest and taxes as such. This question in turn depends upon the ownership of the apartment building, since the interest accrued and the taxes were levied upon the building and real estate.

There can be no doubt that interest and taxes of the kind here involved, when liability is incurred and they are in fact paid as such by the taxpayer in the taxable year, constitute allowable deductions from gross income. Sec. 23(b) and (c), Revenue Act of 1928. However, where a taxpayer pays the interest and taxes of his creditor, or makes such payments in behalf of another person, either individual or corporate, they do not represent interest and tax obligations of the taxpayer and are not deductible as such by him.

In paragraph 4 of the stipulation of the parties, . . . it is stated that the "title to the land and building" here involved "is in the 1320 North State Street Building Corporation, an Illinois corporation," and in paragraph 5 of the same stipulation it is stated that "during the years 1928 and 1929 the petitioner owned and maintained his co-operative apartment under the terms of a certain proprietary lease between himself and 1320 North State Street Building Corporation." These are conflicting and contradictory stipulations, since the petitioner could not have "owned and maintained" his co-operative apartment if the title to the land and building was in the corporation; and the designation of the lease contract as a "proprietary lease" is a contradiction in terms, because a proprietor or owner can not at the same time be a lessee of his own property.

However, disregarding these apparent conflicts in the stipulation, we think it is clear that under the lease contract the petitioner was in no sense the proprietor or owner of the apartment which he had leased. The apartment was leased to him by the owner, the building corporation, for a period of 100 years from 1925, or until the year 2025, in consideration, among other things, of the payment by the petitioner to the corporation of certain monthly payments as rental, and other payments stated not to be rent, and also additional capital contributions, to all of which further reference will be made. Furthermore, the lease of the apartment to the petitioner was expressly conditioned upon the right of the building corporation, the owner, to sell the entire building and premises at any time, in which

event the lease contract provides, in paragraph 1(a) of Title IV, that "this lease and all the right, title and interest of the Lessee hereunder shall terminate at the expiration of ninety (90) days from and after written notice thereof."

The petitioner, in consideration of the demise and lease of said apartment, agreed to pay, specifically as rental, the sum of one dollar per year, and, specifically as additional rental, his proportionate part of the cost of maintenance and operation of the building upon the basis of his stock ownership in the corporation.

The lease contract, in paragraph 2 of Title I, provides that "In further consideration of said demise the Lessee covenants and agrees to pay to the Lessor or for its account (but not as rent), the following:". There is then set out in subparagraph (a) of said paragraph a detailed description of the interest and taxes which the petitioner agreed to pay and which are the subject matter of the controversy herein.

The petitioner in his brief lays stress upon the fact that it is provided in the lease contract that the interest and taxes were not payments of additional rent. But we think no argument or citation of authority is necessary to support the elemental proposition that, if the circumstances of the case establish that the payments of interest and taxes were made as part of the consideration for the lease of the apartment, then they constituted additional rent, and such fact is not changed and can not be disregarded because of a contrary statement contained in the lease contract between the petitioner and his lessor. However, notwithstanding said statement in the lease contract, we think a fair construction of the provisions of that contract clearly indicates that the interest and taxes paid by the petitioner constituted nothing more nor less than additional rental. The very language used in the paragraph above quoted describes the payments as "in further consideration of said demise," that is to say, as further consideration for the lease of the apartment, which is the equivalent of additional rental. The only items of rental or consideration for the demise theretofore stated in the contract consists of the cash rental of one dollar per year and the petitioner's proportionate part of the operating expenses. Subdivision (b) of paragraph 2 of the lease contract provides for the payment by the petitioner of his proportionate part of the principal amount of the funded indebtedness of the lessor, special assessments for local improvements, and the cost of improvements to the building, all of which it is provided should constitute additional capital paid to the lessor by the lessee as a stockholder. Thus it would appear that the interest and taxes in question were not intended by the parties as additional capital contributions.

If we should be in error in viewing these payments of interest and taxes as additional rental under our construction of the lease contract, they would nevertheless not constitute allowable deductions from the petitioner's gross income, for the reason that interest and taxes were the direct obligations of the building corporation which owned the apartment house, and were merely paid by the petitioner for and in its behalf. The petitioner does not contend and has not attempted to show that the payments are deductible as a business expense, or otherwise than as interest and taxes. In the circumstances disclosed, the payments are not allowable deductions from the gross income of the petitioner. *Caroline T. Kissel*, 15 B.T.A. 1270, 1274; *William Ainslee Colston*, 21 B.T.A. 396, 399; affd., 59 Fed. (2d) 867; certiorari denied, 287 U.S. 640.

Note

1. The Code was amended in 1942 to allow the tenant-stockholder of a cooperative apartment building to deduct his share of the corporation's interest and taxes and in 1954 the provision, now § 216, was broadened to include cooperative housing developments.

Interest may of course be incurred in business or in a transaction entered into for profit; and the deduction in such circumstances rests upon the same footing as any other expense of business or investment; see Ch. 3, Sec. A. But it may also be a purely personal expense, as when paid to finance the purchase of one's private residence or car. Why should such expenses be deductible when the cost of rent, food, and clothing is not?

2. Section 163(b) allows a deduction for "hidden" interest on installment purchases. Before 1954, this area was in some doubt. See *McKenzie* v. *Commissioner*, 1952, ¶ 52,126 P-H Memo TC; *cf. Hundahl* v. *Commissioner*, 118 F.2d 349 (5th Cir. 1941).

3. As to the Court's second point, expressed in the last paragraph, would it prevent the deduction of interest by a taxpayer who owns property subject to a mortgage which he did not assume and on which another party is primarily liable? *New McDermott, Inc.* v. *Commissioner*, 44 B.T.A. 1035 (1941).

4. As to the deductibility of interest on intra-family indebtedness, see Ch. 4, Sec. C(5).

5. Why the restriction in § 265(2) disallowing the deduction for interest on indebtedness "incurred or continued" to purchase tax-exempt securities? Note that it is applicable only if the interest received is *wholly* tax-exempt; the interest on some federal obligations is exempt from the normal tax but not from the surtax. How is the causal connection to be established, especially as to indebtedness "continued" for the forbidden purpose? (The parenthetical exception to the exception is of declining importance, since interest on federal obligations issued since 1941, see *supra*, p. 154, is fully taxable and, as to those issued previously, only the original subscribers are protected by the parenthetical clause.). The restriction now found in Section 265(1) was held constitutional in *Denman* v. *Slayton*, 282 U.S. 514 (1931).

6. Section 264 similarly disqualifies interest on indebtedness incurred or continued to purchase or carry "single premium" life insurance, annuity, or endowment contracts. The tax avoidance device thus frustrated is the deduction of interest on a loan taken out to pay the insurance premium without the recognition of any income from the earnings credited by the insurance company on the premium. If premiums are stretched out over four years or more, the policy is not a "single premium" one, however, and some fancy footwork may still be feasible. There is also a problem of ascertaining whether indebtedness is incurred or continued in order to purchase or carry the policy.

5. Taxes

Section 23(c) of the 1939 Code, allowing certain taxes to be deducted, was re-enacted with one minor substantive and several clerical changes by §§ 164(a), (b), and (c) of the 1954 Code.

Section 164(d) of the 1954 Code is new.

See Regs. 118, Sec. 39.23(c)-1, -2, and -3.

I.T. 3511

Bureau of Internal Revenue, 1941

1941-2 C.B. 90

Advice is requested with respect to the deductibility for Federal income tax purposes of fees paid for dog licenses, automobile inspection, and automobile title registration, assuming that such fees are not classifiable as business expenses.

As a general rule, dog license fees are collected to defray the expenses of main-

taining dog pounds, etc. Automobile inspection fees are collected primarily to cover the cost of periodical inspection of automobiles and for upkeep of inspection stations Automobile title registration fees generally represent amounts paid for title registration certificates which are required to be delivered to purchasers upon transfers of automobiles.

The primary question in determining whether the above-mentioned items are deductible from gross income for Federal income tax purposes is whether they are deductible as "taxes" under section 23(c) of the Internal Revenue Code. In general, the term "tax" includes every burden that may lawfully be laid upon the citizen by virtue of the taxing power, but its application in statutory provisions varies with the intent and purpose of the particular provision. A tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and not as a payment for some special privilege granted or service rendered. Taxes are, therefore, distinguishable from various other charges imposed for particular purposes under particular powers or functions of government. In view of such distinctions, the question whether a particular charge is to be regarded as a tax depends upon its real nature. If it is in the nature of a tax, it is not material that it may be called by a different name; conversely, if it is not in the nature of a tax, it is not material that it may be so called.

In 26 Ruling Case Law, page 17, the general rule distinguishing taxation from regulation is stated in the following language:

> 4. Taxation distinguished from regulations.—Some governments derive a considerable revenue from a judicious exercise of the power of regulation; but since a tax is a charge imposed for the purpose of raising revenue, a charge primarily imposed for the purpose of regulation is not a tax, and is not subject to the constitutional limitations upon the power of taxation. . . . If the primary purpose of the legislature in imposing such a charge is to regulate the occupation or the act, the charge is not a tax, even if it produces revenue for the public . . .

Generally, the fees here involved are nominal in amount and are collected primarily for regulatory, not for revenue-producing purposes. The funds collected are used to defray expenses of regulation. Since the fees are usually for regulatory as distinguished from revenue-producing purposes and are not collected as "taxes," they are not ordinarily deductible as taxes under section 23(c) of the Internal Revenue Code. This conclusion is in accord with the principles of I.T. 2796 (C.B. XIII-2, 48 (1934)), involving the cost of hunting and fishing licenses in the State of North Dakota; I.T. 2999 (C.B. XV-2, 139 (1936)), involving the cost of Federal migratory bird hunting stamps and hunting licenses in the States of New York, North Carolina, and Pennsylvania; I.T. 3166 (C.B. 1938-1, 133), involving the cost of hunting and fishing licenses in the State of Ohio; and I.T. 3365 (C.B. 1940-1, 31), involving amounts deposited in parking meters in the District of Columbia.

Note

1. Would the parking meter charge become deductible if the statute were amended to provide: "The installation of parking meters is hereby declared to be a revenue-raising rather than regulatory measure?" Note that Regs. 118, Sec. 39.23(c)-1(a) provides that automobile license fees are "ordinarily" taxes.

2. If the tax is incurred in the taxpayer's trade or business or in connection with property held for the production of income, it may be deducted under § 162(a) or (in the case of a sales tax, *e.g.*) treated as part of the cost of the business asset and written off through the depreciation allowance. But what is the reason for allowing taxpayers to deduct under § 164 taxes that are purely personal? What theory underlies § 164's demarcation between deductible and non-deductible taxes?

3. Sales and similar taxes have engendered difficulty far beyond their importance to the average taxpayer. Even before 1942, when the predecessor of § 164(c) was enacted, a sales tax imposed on and paid by the purchaser of goods was deductible, even though it was collected by the vendor and by him remitted to the authorities. I.T. 2902, XIV-2 C.B. 67 (1935), involving the New York City sales tax. But it took very little to find that the tax was not merely *collected* by the vendor but was instead imposed upon and paid by him. Then, under what is now section 164(a), the tax could not be deducted by the vendee, because to him it was not a tax but part of the cost of his purchase. See, *e.g.*, G.C.M. 15101, XIV-2 C.B. 65 (1935). Presumably to put vendees in different states on a par as to such items as cigarette taxes, § 164's prototype was enacted. It is no longer necessary to show that the vendee is "the taxpayer"; if the statute's other conditions are met, the tax will be deductible though imposed on and paid by the vendor. But the chain-smoker in State A is still not on a par with his fellow slave in State B, though both pay the same price for cigarettes. For State A's tax may be imposed on the retailer, and hence deductible, while State B's tax is imposed on the wholesaler and hence will not qualify. *Commissioner* v. *Thompson*, 193 F.2d 586 (10th Cir. 1951). Sometimes a change in label has made the tax deductible. Thus, the Oklahoma tax that was held non-deductible in the case just cited was held to qualify after the Oklahoma statute was amended to provide:

> The impact of the tax levied by this Act is hereby declared to be on the vendee, user, consumer, or possessor of cigarettes in this State and when said tax is paid by any other person such payment shall be considered as an advance payment and shall thereafter be added to the price of the cigarettes and recovered from the ultimate consumer or user. . . . The provisions of this Section shall in no way affect the method of collection of such tax on cigarettes as now provided by existing law.

Rev. Rul. 54-50, 54-1 C.B. —. See also Rev. Rul. 54-132, 54-1 C.B. —, holding a similar amendment to the Massachusetts cigarette tax law to be effective, I.T. 4059, 51-2 C.B. 24. In 1951 the statute was amended to provide that in the case of gasoline, a tax upon either the wholesaler or the retailer will qualify.

Another problem of characterization that can arise under § 164(c) is whether the tax is levied on a sale, or merely on the possession of the property, albeit by one in trade who intends to sell. A tax levied on possession alone is not deductible under § 164(c), even though the tax is added to the price and separately stated and even though possession rather than sale was selected as the formal taxable event only for ease of enforcement. *Commissioner* v. *Thompson*, *supra.*

Why has there been so much difficulty here? Is there any reason for allowing taxes to be deducted if separately stated but not otherwise?

4. Suppose the real property tax on *A's* home for the year 1955 is based on its assessed value as of June 30, 1954, and must be paid in full before June 30, 1955. *A* pays the tax on June 1, 1955, but sells his house on July 1, 1955, the buyer paying the agreed price plus 50 per cent of the 1955 tax. See § 164(d), which, when applicable, overrules *Magruder* v. *Supplee*, 316 U.S. 394 (1942).

6. *Casualty Losses*

Note: **Section 23(e)(3) of the 1939 Code, allowing a deduction for casualty losses, and § 23(i), prescribing the method of determining the amount of the deduction, are re-enacted by Sections 165(a), (c)(3), and (b) of the 1954 Code.**

Section 165(e), prescribing the time for deducting losses by theft, is new.

See Regs. 118, Sec. 39.23(e)-1.

KEENAN v. BOWERS

U. S. District Court, Eastern District, South Carolina, 1950
91 F. Supp. 771

WYCHE, Chief Judge. . . .

On March 15, 1945, the taxpayers, husband and wife, filed a joint federal income tax return for the tax year 1944, and in their computation of net taxable income claimed a deduction of $1,300 under Section 23(e) (3), Internal Revenue Code, 26 U.S.C.A. § 23(e) (3), for the loss of two diamond rings not compensated for by insurance, which deduction was disallowed by the Commissioner, and an assessment made for additional taxes in the amount of $972.02, plus $180.38 interest, which was paid under protest by plaintiffs. A claim for refund was duly filed by plaintiffs and disallowed.

The stipulation by the parties and the affidavit of Mrs. Keenan, which was agreed to be considered as testimony for the plaintiff, disclose the following facts: On or about May 4, 1944, Mr. and Mrs. W. J. Keenan, the plaintiffs herein, were en route to visit their son at Grenada, Mississippi, prior to his departure overseas with the 94th Infantry, and they stopped and spent the night at the Bankhead Hotel in Birmingham, Alabama; they had never spent the night in said hotel before and the surroundings were strange to both of them; their hotel room had single beds with a small lamp table between the beds. This arrangement differed from that in their home where they had bed tables on each side. On this night, Mr. Keenan prepared for bed, and being bothered with a nose irritation, placed a box of kleenex tissues on his side of the bed table and went to sleep prior to Mrs. Keenan. Subsequent to this, his wife retired. Customarily, when retiring at home, Mrs. Keenan removed her rings and placed them on or in her bureau, but this night she did not do so. However, during the night, she found her rings uncomfortable, and recalling the box of kleenex on the table, she reached out in the dark and unbeknown to her husband, took a piece of kleenex and wrapped her rings in it, and placed them wrapped on her side of the small table; she wrapped them in kleenex tissue with the thought in mind that this would be a possible precaution against the theft of the rings; during the night, Mr. Keenan awoke several times, used pieces of kleenex tissues to blow his nose, and having no convenient waste basket at hand, placed these balls of tissue on the table, intending to dispose of them upon rising, the next morning, Mr. Keenan arose early and prior to his wife's awakening, hastily preparing for an early departure, swept the used tissues up, not knowing that some of them contained the rings, balled them up, went to the bathroom and disposed of them in the toilet, flushing it forthwith; about a half an hour after Mr. Keenan's actions, Mrs. Keenan realized what had happened and immediately communicated with the hotel manager who called in the hotel engineer. A search of the trap was to no avail and then later the City of Birmingham's engineer went into the large trap in the sewer into which the hotel refuse emptied but all efforts to recover the rings were unavailing. The value of these

rings, less the maximum amount of insurance which could be collected, was $1,300.

Section 23(e) (3) of the Internal Revenue Code, 26 U.S.C.A. § 23(e) (3), upon which the claim for deduction is based, provides as follows. In computing net income there shall be allowed as deductions. "In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise— . . . of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, *or other casualty*, or from theft. . . ." (Emphasis added).

The question for decision is whether or not the phrase "other casualty" in the statute can be construed so as to cover the loss of jewelry under the foregoing agreed statement of facts. . . .

Generally, the words "other" and "any other" following an enumeration of particular classes of things in a statute, must be read as meaning "other such like" and include only words of like kind or character. . . .

The word "casualty" has been defined as follows:

> An accident or casualty, according to common understanding, proceeds from an unknown cause or is an unusual effect of a known cause. Either may be properly said to occur by chance and unexpectedly. *Chicago, St. Louis & N. O. R. Co.* v. *Pullman Co.*, 139 U.S. 79, 11 S. Ct. 490, 493, 35 L. Ed. 97.

See also, *Alice P. Bachofen Von Echt*, 21 B.T.A. 702, 709. "Casualty" has also been defined as "an event due to some sudden, unexpected, or unusual cause," *Matheson, Exec.* v. *Comm.*, 2 Cir., 54 F.2d 537, 539; and embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design on the part of the one who suffers the loss. However, it is now recognized that a human agency can constitute or cause the sudden turn of events resulting in the loss. *Ray Durden et al.*, 3 T.C. 1; *Robert L. Stephens* v. *Commissioner*, 3 T.C. 1.

The words "other casualty" were added by the 1916 Act, and the Treasury at first took the view that "other casualty" must be an incident similar to fires, storms or shipwreck arising from a natural cause and not due to negligence. In *Shearer* v. *Anderson*, 2 Cir., 16 F.2d 995, 996, this construction was held to be erroneous and the court, in allowing a deduction for damage to the taxpayer's pleasure automobile sustained when it overturned on an icy road, stated: ". . . as 'casualty' expresses rather the result than the cause of the damage, that is, the wreck itself rather than the lightning, storm, or the negligence or fault of some person, so the 'other casualty' is at least as clearly ejusdem generis (of the same kind) with shipwreck as with fire or storm." The court's modification of the Treasury Regulations in the case of *Shearer* v. *Anderson*, 2 Cir., 16 F.2d 995, does not change the Treasury's construction that the phrase means *or other like casualty*, because the court, in allowing a deduction for the damages resulting from the automobile wreck, held that the wreck of the automobile was similar to a shipwreck and was a casualty of the same kind.

Some of the losses which have been held to be deductible as from "other casualty" are as follows: loss occasioned by freezing and bursting of water pipes in a residence during the absence of the occupant; loss occasioned by the bursting of a boiler used in heating a taxpayer's residence; damage to a factory from an earthquake; an extensive deep sinking of land caused by a subterranean disturb-

ance; damage to trees caused by a sleet and ice storm; loss from violent quarry blasting operations.

Examples of losses that have been held not to be from "other casualty" are as follows· damage to buildings caused by termites; loss of a ring when there was no evidence or testimony establishing that the ring was stolen rather than mislaid, and the taxpayer did not attempt to establish the fair market value of the ring as of the date of disappearance; loss of a ring when it slipped from taxpayer's finger and was lost in muddy water when he was trying to retrieve a decoy while duck hunting; damage to a residence caused by excavations on property adjoining that of the taxpayer, loss occasioned by rusting and corrosion of the re-enforcing steel used in the cement floor beams of a house built on an island, damage on account of injuries caused to one who trips over a wire stretched in front of the taxpayer's residence, loss of household goods either in storage or in transit, and loss of a bird dog which disappeared when released for exercise by its handler and was never seen again. Mertens, *Law of Federal Income Taxation*, § 28.57, pp. 215, 216, and the 1950 Cumulative Pocket Supplement, p. 98. . . .

In the case of *United States* v. *Rogers*, 122 F.2d 485, the Circuit Court of Appeals for the Ninth Circuit said:

The meaning of the word "casualty" as used in the statute depends upon the context. The doctrine of ejusdem generis requires the statute to be construed as though it read "loss by fires, storms, shipwrecks, or other casualty of the same kind".

See also, *Matheson* v. *Commissioner*, 2 Cir., 54 F.2d 537.

So, the question here is whether or not the loss of the two diamond rings by the taxpayers may be classified as a casualty of the same kind as a loss by "fires, storms, shipwreck."

The case nearest in point is *Stevens* v. *Commissioner*,[1] decided July 8, 1947, where the taxpayer, while duck hunting and in the act of retrieving a decoy, a ring belonging to him, slipped off his finger and dropped into muddy water several feet deep. Although he was conscious of the fact at the moment the ring slipped from his finger, it disappeared into the muddy water making all efforts to recover it futile. In this case the Tax Court disallowed the deduction and said.

The loss here was not like that resulting from the collision of an automobile, *Shearer* v *Anderson, supra; W. S. Bronson*, 9 B.T.A. 1008; or a flood, *Ferguson* v *Commissioner*, 10 Cir., 59 F.2d 893; or an ice storm, *Frederick H Nash*, 22 B.T.A. 482, or subterranean disturbances, *Harry Johnston Grant*, 30 B.T.A 1028. The petitioner merely permitted his ring to drop from his finger, by his own carelessness, we must presume, without the intervention of any sudden or destructive force. It was much the same kind of loss as might result from the loss of one's purse, or any other article of value. Certainly, if Congress had intended to allow the deduction of such losses it would have expressed its aim in language much simpler and more appropriate to that end than is to be found in section 23(e) (3).

In the instant case it may be conceded that the loss of the rings was due to an unexpected and unusual cause and was not an intentional act on the taxpayer's part, but the loss lacks the element of suddenness. The primary cause of the loss was the placing of the rings in the kleenex tissue. The loss was caused by a chain of events on the part of Mrs. Keenan and Mr. Keenan. There was no intervening sudden force, cause or occurrence which brought on the event such as would ever

[1] ¶ 47,191 P-H Memo T.C.

be present in a casualty arising from fires, storms or shipwreck. I cannot say that the event or accident resulting in the loss was of the same kind as would be caused by fire, storm or shipwreck.

Therefore, judgment must be entered for the defendant, and it is so ordered.

Note

1. If the rings had been left in the hotel room when the taxpayers departed, and could not be found by the management when the taxpayers inquired about them a day later, would the loss be deductible? What if the rings had been left on a window sill and had been damaged or lost on being accidentally brushed off by a maid? Can the damage to the taxpayer's own automobile in a collision or upset be deducted if he was driving negligently? Regs. 118, Sec. 39.23(e)-1(c). As to the required "element of suddenness," termites are sometimes like fires, storms, and shipwrecks, *Rosenberg* v. *Commissioner*, 198 F.2d 46 (8th Cir. 1952), and sometimes not, *Fay* v. *Helvering*, 120 F.2d 253 (2d Cir. 1941); *United States* v. *Rogers*, 120 F.2d 244 (9th Cir. 1941). Does § 165(c) allow the taxpayer to deduct the damage done by one snow storm but not the damage done by a cold winter? If so, why? In ruling that a drought might be a "casualty," the Internal Revenue Service has said:

> Court decisions and Internal Revenue Service rulings . . . have developed the over-all concept that the term "casualty" . . . refers to an identifiable event of a sudden, unexpected, or unusual nature. . . . Under this concept, an identifiable event which would give rise to a casualty loss is not necessarily limited to an event of a sudden nature such as a flood, hurricane or earthquake, since it can also be of an unexpected or unusual nature. Thus, in the case of an unprecedented and unusual drought in an area which normally does not have prolonged and continued dry spells, a drought of such nature would be both unexpected and unusual and, therefore, would meet the above-mentioned test of an identifiable event. . . . On the other hand, a dry spell which is normal and usual in the particular area involved, would not meet the test indicated above since a drought of that nature would be neither "unexpected or unusual" for such area. Any loss resulting under such circumstances would be attributable to progressive deterioration of the property through a steadily operating cause and therefore would not constitute a "casualty" loss. Special Ruling addressed to Sen. T. C. Higgins, Jr., printed in 54 P-H Fed. Tax Service ¶ 76,570; see also Rev. Rul. 54-85, I.R.B. 1954-10.

2. Note that only property losses are deductible under § 165(c)(3).

3. Since losses of personal property by casualty are deductible, while premiums paid for insurance against such losses are not, taxpayers in the highest brackets may find it economical to forego insurance, deducting their losses in full as they occur.

4. See generally Caplin, "Casualty Losses: Recent Developments," *12th Annual N.Y.U. Institute on Fed. Taxation* 525 (1954).

HELVERING v. OWENS
OBICI v. HELVERING

Supreme Court of the U. S., 1939

305 U.S. 468

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The courts below have given opposing answers to the question whether the basis for determining the amount of a loss sustained during the taxable year through injury to property not used in a trade or business, and therefore not the subject of an annual depreciation allowance, should be original cost or value

immediately before the casualty. To resolve this conflict we granted certiorari in both cases....

In No. 180 the facts are that the respondent Donald H. Owens purchased an automobile at a date subsequent to March 1, 1913, and prior to 1934, for $1,825, and used it for pleasure until June 1934 when it was damaged in a collision. The car was not insured. Prior to the accident its fair market value was $225; after that event the fair market value was $190. The respondents filed a joint income tax return for the calendar year 1934 in which they claimed a deduction of $1635, the difference between cost and fair market value after the casualty. The Commissioner reduced the deduction to $35, the difference in market value before and after the collision. The Board of Tax Appeals sustained the taxpayer's claim and the Circuit Court of Appeals affirmed its ruling.

In No. 318 it appears that the taxpayers acquired a boat, boathouse, and pier in 1926 at a cost of $5,325. In August 1933 the property, which had been used solely for pleasure, and was uninsured, was totally destroyed by a storm. Its actual value immediately prior to destruction was $3,905. The taxpayers claimed the right to deduct cost in the computation of taxable income. The Commissioner allowed only value at date of destruction. The Board of Tax Appeals held with the taxpayers but the Circuit Court of Appeals reversed the Board's ruling.

. . . Section 23(e) (3) permits deduction from gross income of losses "of property not connected with the trade or business" of the taxpayer, "if the loss arises from . . . casualty." Sec. 23(i) [now § 165(b)] declares that "The basis for determining the amount of the deduction for losses sustained, to be allowed under subsection (e) . . . , shall be the adjusted basis provided in section 113(b)." Section 113 is entitled "Adjusted basis for determining gain or loss", in subsection (a) it provides that "The basis of property shall be the cost of such property," with exceptions not material. Subsection (b), to which 23(i) refers, is

Adjusted basis. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (1) *General rule.* Proper adjustment in respect of the property shall in all cases be made— . . (B) in respect to any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income-tax laws."*

The income tax acts have consistently allowed deduction for exhaustion, wear and tear, or obsolescence only in the case of "property used in the trade or business." The taxpayers in these cases could not, therefore, have claimed any deduction on this account for years prior to that in which the casualty occurred. For this reason they claim they may deduct upon the unadjusted basis,—that is,—cost. As the income tax laws call for accounting on an annual basis; as they provide for deductions for "losses sustained during the taxable year"; as the taxpayer is not allowed annual deductions for depreciation of non-business property; as section 23 (i) requires that the deduction shall be on "the adjusted basis provided in section 113(b)," thus contemplating an adjustment of value consequent on depreciation, and as the property involved was subject to depreciation and of less value in the taxable year, than its original cost, we think section 113 (b) (1) (B)

* Section 113(b)(1)(B), amended in a respect not material to the problem before the court, is now § 1016(a)(2). [Ed.]

must be read as a limitation upon the amount of the deduction so that it may not exceed cost, and in the case of depreciable non-business property may not exceed the amount of the loss actually sustained in the taxable year, measured by the then depreciated value of the property. The Treasury rulings have not been consistent, but this construction is the one which has finally been adopted.

In No. 180 judgment reversed.

In No. 318 judgment affirmed.

Note

1. In allowing Owens to deduct $1,635, the Court of Appeals for the Second Circuit said "... the letter is too plain; we should have to disregard the words, and should not be interpreting them, if we refused to take them just as they read." 95 F.2d 318, 319 (2d Cir. 1938). When, in the Supreme Court's view, does § 1016(a)(2) come into play as "a limitation upon the amount of the deduction?" If by reason of inflation property damaged by casualty is worth, even after the accident, more than its cost, has the taxpayer suffered a "loss?" Suppose an imported camera purchased by the taxpayer for $150 is stolen from him when it is still as good as new. What is the amount of his loss assuming that he replaces it for $100 because (a) its regular retail price has declined, (b) he happens to be in the country of manufacture and need not pay the United States duty, or (c) his uncle's brother-in-law gets one for him wholesale? If in any of these circumstances his loss is limited to $100, would it matter that instead of replacing the camera he decided to do without? What if when the camera was stolen from the taxpayer its value because of wear and tear was $100, but because the taxpayer was on an expedition and had immediate need for a camera, he was compelled to have a replacement shipped to him by chartered plane? What is the deduction if when the camera is stolen its "fair market value" is $100 if sold by a store but only $75 if offered for sale by a private individual?

2. If the property involved in the cases had been used in the taxpayer's trade or business, would the deductions have been different in amount? See G.C.M. 6122, VIII-2 C.B. 115.

3. In *Reporter Publ. Co.* v. *Commissioner*, 201 F.2d 743 (10th Cir. 1953), the taxpayer, which had paid about $80,000 for a membership in the Associated Press, deducted $30,000 as a loss when the Supreme Court, in *Associated Press* v. *United States*, 326 U.S. 1 (1945), held that a provision giving members a veto over the admission of new members in their territory was invalid. (The taxpayer, being engaged in trade or business, was not restricted to losses caused by casualties under § 165(c)(3), but could rely instead on § 165(c)(1).) The deduction was denied, although the court conceded that the Supreme Court's decision decreased the value of the taxpayer's Associated Press membership:

> It is no doubt much less desirable since the holder thereof may no longer prevent a competitor from having such a membership. But this is a far cry from saying that it is valueless The present membership still enables the taxpayer to receive all the services therefrom that he received before the decision by the Supreme Court. . . . If the membership had no value or utility, it would be a simple matter to surrender it and eliminate it entirely from the business. Then appellant would be entitled to the claimed deduction. But so long as the membership is being retained and used in the business, in the same way, for the same purposes and with the same beneficial results, it cannot be said to have no value.

What if the automobile collision that led to the deduction in *Helvering* v. *Owens*, *supra,* had caused some body dents reducing the car's value but not interfering with its operation?

4. Assume that Jones pays $2,000 for an automobile and that when it is damaged in a collision he takes a $500 casualty loss deduction Thereafter he spends $200 to repair part of the damage and, because of an inflation in automobile prices, sells the car the next year for $2,300. What is his profit on the sale?

ALISON v. UNITED STATES
UNITED STATES v. STEVENSON-CHISLETT, Inc.

Supreme Court of the U S, 1952
344 U.S. 167

Mr. Justice Black delivered the opinion of the Court.

The questions in these two income tax cases are so much alike that they can be treated in one opinion. Both taxpayers had moneys embezzled by trusted agents and employees. As usual, the defalcations had been going on for many years before they were discovered. On discovery, efforts were made immediately to identify the takers and fix the dates and amounts of the thefts. In the *Alison* case, No. 79, the books revealed the thief and the precise amounts taken each year from 1931 to 1940. In No. 80, Stevenson-Chislett, Inc., the cover-up had been so successful that painstaking investigation failed to reveal who took the funds or the time when the unascertained person or persons took them Each taxpayer claimed a tax deduction for the year the losses were discovered and their amounts ascertained. The Government objected, claiming that the deduction should have been taken in each of the prior years during which the moneys were being surreptitiously taken. In the *Stevenson-Chislett* case, the District Court held that the uncertain circumstances of the embezzlement entitled the taxpayer to take its losses the year the loss was discovered and the amount ascertained. 98 F. Supp 252. The District Judge decided the other way in the *Alison* case and denied her declarations. D.C., 97 F. Supp. 959. His holding, however, was not in accord with his own views, but was compelled, he thought, by the Third Circuit's decision in *First National Bank of Sharon, Pa.* v. *Heiner*, 66 F.2d 925. The Court of Appeals for the Third Circuit certified to us the question of deductibility in both cases. Pursuant to 28 U.S.C. § 1254(3), 28 U.S.C.A. § 1254(3), we ordered the complete records sent up so that we might decide the entire matters in controversy.

Internal Revenue Code, § 23(e) and (f), 26 U.S.C.A. § 23(e, f), authorize deductions for " . . . losses sustained during the taxable year. . . ." The Government reads this section as requiring a taxpayer to take a deduction for loss from embezzlement in the year in which the theft occurs, even though inability to discover in time might completely deprive the taxpayer of the benefit of this statutory deduction. Only at the time the money is stolen, so it is argued, is a loss "sustained." But Treasury practice itself belies this rigid construction. For more than thirty years the Regulations have provided that "A loss from theft or embezzlement occurring in one year and discovered in another is *ordinarily* deductible for the year in which sustained." Regs. 118, Sec. 39.43-2. (Emphasis supplied.) Information contained in a letter from the Commissioner attached as an appendix to the Government's brief cites many instances in which the Treasury has allowed deductions for embezzlement losses in years subsequent to those in which the thefts occurred. Apparently the Department has felt constrained to do this in order to prevent hardships and injustice. These have been departures from the "ordinary" rule of attributing embezzlement losses to the year of theft.

This Treasury practice evidently stems at least in part from the special nature of the crime of embezzlement. Its essence is secrecy. Taxpayers are usually well aware of all the circumstances of financial losses for which tax deductions are allowed. Not so when a trusted adviser or employee steals. For years his crime

may be known only to himself. He may take money planning to return it and he may return it before there is discovery. Furthermore, the terms embezzlement and loss are not synonymous. The theft occurs, but whether there is a loss may remain uncertain. One whose funds have been embezzled may pursue the wrongdoer and recover his property wholly or in part. See *Commissioner of Internal Rev.* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546, 90 L. Ed. 752. Events in the *Alison* case show the practical value of this right of recovery. A substantial proportion of the embezzled funds was recovered in 1941, ten years after the first embezzlement occurred. This recovery alone is ample refutation of the view that a loss is inevitably "sustained" at the very time an embezzlement is committed.

Whether and when a deductible loss results from an embezzlement is a factual question, a practical one to be decided according to surrounding circumstances. See *Boehm* v. *Commissioner*, 326 U.S. 287, 66 S. Ct. 120, 90 L. Ed. 78. An inflexible rule is not needed; the statute does not compel it. For years the Treasury has administered the tax law under regulations saying that deductions shall "ordinarily" be taken in the year of embezzlement. Ordinarily does not mean always.

We hold that the special factual circumstances found by the District Courts in both these cases justify deductions under I.R.C. § 23(e) and (f) and the long-standing Treasury Regulations applicable to embezzlement losses. See *Boston Consolidated Gas Co.* v. *Commissioner*, 1 Cir., 128 F.2d 473; *Gwinn Bros. & Co.* v. *Commissioner*, 7 T.C. 320. Accordingly, the judgment in No. 79 is reversed and the judgment in No. 80 is affirmed.

It is so ordered.

Judgment in No. 79 reversed and judgment in No. 80 affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent.

Note

1. Section 165(e), added in 1954, provides that a loss arising from theft (which according to the S. Rept., p. 198, includes "embezzlement, larceny, etc.") "shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." Does a taxpayer discover a "loss" when he finds that an employee took money from the cash register or only when he finds that the employee is unable to pay it back? In order to claim the deduction, must the taxpayer show that the embezzled funds cannot be recovered from the employee? *G. M. Still, Inc.* v. *Commissioner*, 19 T.C. 1072, 1075–76 (1953). If the employer decides not to press the embezzler for payment because this would—for example—require a foreclosure of his home, has the employer sustained a loss?

2 Sometimes the amount of a loss caused by storm or similar casualty is not known in the year of the catastrophe, either because the extent of the damage is not yet ascertainable or because the taxpayer does not know how fully he will be compensated by insurance. In several cases, the loss has been held deductible when finally measured. *Barrett* v. *United States*, 102 F. Supp. 956 (W.D. Ia. 1952); *Commissioner* v. *Harwick*, 184 F.2d 835 (5th Cir. 1950). In 1942, recognizing the difficulty of ascertaining when property was lost in wartime, Congress enacted § 127 of the 1939 Code. Property under enemy control when war began was irrebutably presumed to be seized or destroyed when war was declared. Section 127(a)(2). With respect to other property, the taxpayer could select his own date, within limits. Section 127(a)(1). See *Andriesse* v. *Commissioner*, 12 T.C. 907 (1949); *Shahmoon* v. *Commissioner*, 185 F.2d 384 (2d Cir. 1950).

7. *Bad Debts*

Note: Section 23(k) of the 1939 Code, dealing with bad debts, was carried over, with some changes, by §§ 166 and 165(g) of the 1954 Code.

See Regs. 118, Sec. 39.23(k)-1, -2, and -6.

SMYTH v. BARNESON

U. S. Circuit Court of Appeals, Ninth Circuit, 1950
181 F.2d 143

Before: STEPHENS, HEALY and POPE, Circuit Judges.

STEPHENS, Circuit Judge.

The Collector of Internal Revenue is appealing from a judgment of the district court decreeing a refund to a taxpayer. The controversy arises out of the disallowance by the Commissioner of Internal Revenue of a $150,000 bad debt deduction taken by appellee on her 1941 individual federal income tax return.

The case comes to us upon stipulation of facts supplemented by the testimony of one witness for appellee and one, an Internal Revenue agent, for the Collector. The refund was decreed upon the finding that the questioned debt existed on January 1, 1941, and was then of value and that it became worthless during the ensuing year. Internal Revenue Code § 23(k) (1).

The Collector thinks the alleged debt never existed but that if it ever existed the sum of the loss cannot be taken as a bad debt deduction because the taxpayer failed to take reasonable steps to collect it.

In order to rule with appellant Collector as to the non-existence of the debt, we must determine that the court's contrary finding was clearly erroneous. In determining this point we consider all of the evidence giving the written evidence the weight we deem it entitled to *de novo* and applying the oral evidence with "due regard . . . to the opportunity of the trial court to judge of the credibility of the witnesses." Rule 52(a), Federal Rules of Civil Procedure, 28 U.S.C.A.

The facts, in brief, are: In 1928 and 1929 the taxpayer advanced to her father $150,000. He used the money, and a like amount secured from his wife, taxpayer's mother, together with some of his own personal funds, to invest in a brokerage firm. The amounts so advanced were entered in the father's books in individual loan accounts. Yearly returns from such investment were received by the father up until 1932, and divided by him with his wife and daughter in the ratio of their advancements to him. On taxpayer's tax returns for the years thus involved, such monies as she received from her father were reported as income from partnership except for one year in which it was reported as interest. In 1932 the firm failed, and the father took on his tax return for that year a loss for the total amount invested although he derived no tax benefit therefrom. Taxpayer had income tax liability for that year which would have been eliminated if she had taken as a loss the amount advanced to her father. Thereafter, the father paid nothing to taxpayer. Taxpayer was adjudged incompetent in 1936 and a brother was appointed her guardian. Shortly thereafter in 1936 the mother died and the brother was appointed executor of the mother's estate. In the same year the father voluntarily informed the executor that he owed his deceased wife

$150,000 and that he owed a like amount to taxpayer, and that he intended to pay both debts. The $150,000 thus stated by the father to be owing to his deceased wife he paid to her estate in 1937, and the loan account as to her on his books was closed out. The father died in 1941, and a claim for the $150,000 filed against his estate by taxpayer's guardian was rejected in 1941 as being barred by the statute of limitations. The father, at all material times, was financially able to pay such amount to the taxpayer. The alleged debt was never listed as an asset on any of the inventories filed with any court by taxpayer's guardian. No note or other evidence ever indicated an obligation on the part of taxpayer's father to repay to her the $150,000.

All the above facts were stipulated to except for the testimony of taxpayer's brother, her guardian, as to the conversation had with the father in 1936 in which the latter stated that he owed taxpayer $150,000.

If the trial court assumed, which it evidently did, that taxpayer's guardian spoke the truth, the father's declaration against interest as to his indebtedness to his daughter was amply sufficient to sustain the finding that the debt was existent at the time. Upon the whole record, we hold that the trial court's finding was not clearly erroneous. Compare *Orvis* v. *Higgins*, 2 Cir., 180 F.2d 537.

As a basis for argument only and after making it plain that he believes the alleged debt never existed, the Collector assumes that the debt did exist and that it became worthless in 1941. He then contends that the "taxpayer is nevertheless not entitled to a bad debt deduction . . . unless she had made a reasonable effort to collect the debt." This she did not do.

Section 23(k) (1) of the Internal Revenue Code authorizes a deduction for "Debts which become worthless within the taxable years . . ."[1] The statute requires, as the basis for a deduction, that a debt actually existed and that it became worthless within the taxable year in which the deduction is claimed. Appellant would have us add a third requisite, *i.e.*, that a reasonable effort must have been made to collect the debt.

It is true that the evidence as to efforts to collect is relevant as to the time a debt actually becomes worthless but, by and of itself, effort to collect is not an element of worthlessness. Authorities cited by the Collector do not hold contrariwise. In the instant case the death of taxpayer's father and the rejection of her claim against his estate in 1941 established its noncollectibility and therefore worthlessness. This fact alone is not conclusive of when it became noncollectible or worthless. But the trial court after consideration of all the evidence was of the opinion that the debt existed and that it might well have been paid at any time before the father's death. Notwithstanding the fact that the statute of limitations could have been pleaded as a complete bar prior to 1941, the debt was existent and at any time might have been paid voluntarily by the debtor [he paid $150,000 into his wife's estate] and could have been collected through court action up to the moment of the debtor's death, except for a special plea setting up the statute of limitations in bar. After the debtor's death, the law, California Probate Code,

[1] Internal Revenue Code § 23(k) (1) as in effect in 1941 authorized a deduction for "Debts *ascertained* to be worthless and charged off within the taxable year . . . " By the Revenue Act of 1942, § 124(a) and (d), 56 Stat. 820, 822, such section was amended to read "Debts which *become* worthless within the taxable year . . ." and as amended was made applicable retroactively to taxable years beginning after December 31, 1938.

§ 708, prevented the payment of any debt as to which the statute of limitations had run.

We discern no mistake in the findings of fact, conclusions of law, and judgment. Compare *United States* v. *United States Gypsum*, 1948, 333 U.S. 364, 68 S. Ct. 525, 92 L. Ed. 746.

Affirmed.

Note

1. Whether an intra-family transaction is a gift or a loan is frequently litigated; the Tax Court has said that transfers from husband to wife are presumed, though not irrebutably, to be gifts. *Van Anda* v. *Commissioner*, 12 T.C. 1158 (1949), aff'd w.o.op., 192 F.2d 391 (2d Cir. 1951). Section 166(d), which came into the Code in 1942, provides that "non-business" bad debts give rise to capital loss rather than to ordinary loss. The significance of this provision will be made clear in Chapter 5, but it may be noted here that capital losses are of restricted deductibility. Section 166(d) will apply to many intra-family transactions, but it embraces other non-business debts as well.

2. In 1952, Congress enacted § 271, providing that uncollectible loans to political organizations shall not be deductible, except by banks. Political *contributions* are not deductible (why not?), and § 271 puts *loans*, which might be used as disguised contributions, on a par with contributions. See *infra*, p 255.

3. As the footnote in the principal case indicates, the statute formerly permitted the deduction only if the debt was "ascertained to be worthless and charged off within the taxable year." If the taxpayer kept no books, a "mental charge-off" might do. Where books were kept, however, it was possible that the deduction would be lost altogether. For the debt might become worthless in one year but (because of unwarranted optimism) the taxpayer's ascertainment of worthlessness and charge-off might have occurred in a later year. Then the year of charge-off would be incorrect, while the earlier year of actual worthlessness could not be used because in it there was no ascertainment of worthlessness and charge-off. Since 1942 the statute has provided that the deduction shall be taken for the year of worthlessness, objectively determined. The selection of the proper year is still something of a guessing game, but since 1942 the taxpayer has been allowed seven years for claiming a refund based on a bad debt, instead of the usual three years. Section 6511(d)(1). Thus if he finds that he was unduly optimistic in waiting until a given year to take the deduction, he will often be able to claim for an earlier year without being met by a statute of limitations defense.

4. Business bad debts are taken up in Chapter 3, Sec. B(7).

Section C. Personal and Dependency Exemptions

Section 151 of the Code allows certain deductions for personal and dependency exemptions. These deductions differ from the personal deductions in that they are allowed even if the taxpayer elects to take the optional standard deduction; and they differ from business deductions in that they do not reduce adjusted gross income and hence do not affect the deductions for charitable contributions and extraordinary medical expenses.

The deductions in question are:

(1) A personal exemption of $600 for the taxpayer himself.

(2) A personal exemption of $600 for the taxpayer's spouse if (a) the taxpayer and his spouse file a joint return, or (b) the taxpayer files a separate return and if his spouse has no gross income and is not claimed as a dependent by another taxpayer.

(3) Each of the preceding exemptions is increased by $600 if the person in question (a) has attained the age of 65 before the close of the taxable year and/or (b) is blind at the close of the taxable year. Thus if both the taxpayer and his spouse are over 65 and blind, the personal exemptions will total $3600.

(4) An exemption of $600 for each "dependent." For the statutory definition of this term, the student should examine § 152.

I.T. 3834

Bureau of Internal Revenue, 1947
1947-1 C.B. 29

Advice is requested whether a veteran who is enrolled for educational training under the Servicemen's Readjustment Act of 1944 (58 Stat., 284), approved June 22, 1944, as amended, may be claimed as a dependent under section 25(b) (1) (C) of the Internal Revenue Code for the calendar year 1946.

In the instant case, the Government, through the Veterans' Administration, pays the veteran's tuition of $500 to an educational institution in accordance with the provisions of section 400(b) of the Servicemen's Readjustment Act of 1944, as amended, frequently referred to as the "G.I. Bill of Rights." While enrolled the veteran also receives from the Veterans' Administration $65 a month which, for a 9-month scholastic period, would amount to more than $500 per year. . . .

Although the benefits (exceeding $500 in value) received by the veteran under the Servicemen's Readjustment Act of 1944, as amended, do not constitute a part of his gross income for Federal income tax purposes, such benefits must be considered in determining whether the parent furnishes more than one-half of the veteran's support for the purpose of section 25(b) (3) of the Code, *supra.* The term "support," generally speaking, includes among other things the cost of education, amounts expended for subsistence, clothing, and medical care, and expenses of a similar character.

If the amount paid for the veteran by the Government to an educational institution, namely, $500, plus the subsistence allowance received by him from the Government for nine months during 1946, namely, $585, a total of $1,805, constitutes more than one-half of the veteran's support, the parent can not be allowed credit for him as a dependent under section 25(b) (1) (C) of the Code, assuming that the subsistence allowance is used by the veteran for his support.

The test to be applied in determining whether a taxpayer has furnished more than one-half of the support of a person claimed as a dependent is one of *actual support.* (See I.T. 3723, C.B. 1945, 122.) If the veteran does not use his subsistence allowance for his support, and the parent furnishes more than one-half of the veteran's actual support, the parent may claim him as a dependent.

Note

1. Note the last sentence. In I.T. 3883, 1947–2 C.B. 38, the Bureau ruled that a di-

vorced husband may claim as a dependent his child, living with the ex-wife and her second husband, where his payments to the ex-wife under court order for the child's support "constituted more than one-half of the amount expended for that purpose, even though the payments are deposited in a special account for [later] use as an educational fund"

On the meaning of "support," see Rev. Rul. 235, 53-2 C.B. 23.

2. The list of relatives set out in § 152 is exclusive. Thus, a nephew will qualify, but not the children of a deceased nephew. *Tilney* v. *Commissioner*, 182 F.2d 1009 (5th Cir. 1950). The solution is adoption. See also § 152(a)(9).

3. Before 1954, the exemption could not be taken for any dependent who had gross income of $600 or more in the taxable year. In *Rives* v. *Commissioner*, ¶ 49,287 P-H Memo T.C., the Commissioner conceded the dependency deduction for a child who earned $500 37 as a delivery boy, although at that time the gross income limitation was $500. The Bureau's generosity may have been stimulated by the fact that the boy had paid $2.50 to repair his bicycle, although the statute reads in terms of *gross*, not *net*, income. The Tax Court would probably have denied the exemption, as it did in *Cohen* v. *Commissioner*, ¶ 53,312 P-H Memo T.C., where a son had received $31.68 too much from part-time employment; although the son's net income was apparently below the statutory amount because of depreciation incurred on equipment, the Court pointed out that the statute takes account only of the dependent's gross income. See also *Gooch* v. *Commissioner*, 21 T.C. No. 60 (1954), where the alleged dependent had certain income from rentals, and the Court held that the gross rentals, rather than net income from the property, were to be used in computing the $600 ceiling.

The 1954 Code eliminated the $600 restriction for children of the taxpayer who are either under the age of 19 or students, as defined in § 151(e)(4). Moreover, § 152(d) provides that scholarships are not to be counted in determining if a child received more than half his support from the taxpayer. Does "scholarship" include amounts paid to a bright student for cutting the grass or sweeping out the gymnasium? See § 117.

Before 1954, the Code required that the taxpayer contribute "over half" of the dependent's support. The exemption was often lost because two or more taxpayers contributed in equal proportions, particularly where several children were supporting a parent. See, *e.g.*, *Russoniello* v. *Commissioner*, 21 T.C. No. 94 (1954). The 1954 Code, by § 152(c), authorizes "multiple support agreements," by which one of several persons supporting the same dependent may be designated by the others to claim the deduction, even though he did not contribute more than half the dependent's support.

4. Note § 73(c), providing that the child's earnings are taxed to him notwithstanding they were paid to the parents. This provision was adopted in 1944. Previously the taxation of such earnings depended upon whether under local law the child or the parent was entitled to them. In most states, this was the parent. See H. Rept. No. 1365, 78th Cong, 2d Sess., 1944 C.B. 821, 837–8.

5. The personal and dependency exemptions raise important issues of policy, but these are best considered in conjunction with the privilege of "income-splitting" extended to married couples and heads of households, Chapter 4, Sec. B.

Section D. Credits against Tax

1 After the tax has been computed, it is reduced by certain credits. The most important is the credit for taxes withheld from wages. Section 31. Any amounts paid as "estimated tax" (*supra*, p. 19) are also credited against the tax liability reported on the return, though these amounts are, strictly speaking, not credits but payments on account of the tax itself. If the taxpayer had any partially tax-exempt interest, he is allowed a credit of 3 per cent thereof. Section 35; *supra*, p. 154. Taxes paid to foreign countries and possessions of the United States are also allowed, to a limited extent, as credits against the federal income tax. See §§ 33 and 901.

2. Section 37 of the 1954 Code introduces a new credit for "retirement income" A qualified taxpayer may credit against his tax liability 20 per cent of his retirement income" (pensions, annuities, interest, rents, and dividends). To qualify, the individual must be over 65 (except that pensions and annuities under a public retirement system qualify even though the recipient is under 65), and he must have received "earned income" in excess of $600 in each of any ten earlier years. In computing the credit, not more than $1,200 of retirement income is taken into account, and even this amount must be reduced by any tax-free pensions or annuities (such as social security benefits) and (unless the individual is over 75) by any earned income in excess of $900 in the taxable year. The announced purpose of the credit (S. Rept. p. 8) is to adjust the differential that previously existed between persons who received federal social security benefits, which have always been tax-exempt, and those who receive taxable pensions or who have provided independently for old age. The parallel to social security is responsible for the 10-year earned income qualification and the reduction of retirement income by earned income over $900, as well as for the 65-year age requirement. The maximum credit for one individual is $240 (*i.e.*, 20 per cent of $1,200), but if a husband and wife each qualify, this may be doubled.

The retirement credit, in conjunction with the additional personal exemption of $600 available to persons over 65, can produce a considerable tax saving. Thus, if both husband and wife are over 65, and if the husband can take full advantage of the retirement credit, the tax on an adjusted gross income of $5,000 (assuming the standard deduction is taken) will be $180 ($420 of tax, less $240 retirement credit) A young couple with two children would pay $420 on the same adjusted gross income, and a young couple without dependents would pay $660.

The provision reducing the amount of qualified "retirement income" by any earned income in excess of $900 will have a curious result for a taxpayer with just $900 of earned income who is offered additional compensation. If, in the foregoing example, the $5,000 of adjusted gross income includes $900 of earned income, and if the taxpayer is offered the opportunity to earn $1200 more, he will not only have to pay the tax on that amount, but will also lose his retirement credit. Thus, an additional $1,200 of earned income will cost him $456 in tax. But the *next* $1,200 of income will cost only an additional $221.20!

3. The 1954 Code also introduced, by § 34, a credit for dividends received by individuals. The first $50 of dividends received by an individual may be excluded from income under § 116, on a joint return the exclusion may be $100 if the husband and wife each has dividends of $50 or more. Section 34 provides that a credit of 4 per cent of the remaining dividends may be taken as a credit. The credit may not exceed 2 per cent of the individual's taxable income in 1954 or 4 per cent in later years. It is allowed in addition to any retirement credit for which the individual may be eligible.

This credit, which was the most controversial aspect of the 1954 Code, will be considered again, Ch. 6, Sec. A, in conjunction with the so-called double taxation of corporate earnings, for which it was intended as a partial antidote.

CHAPTER 3

THE BUSINESS TAXPAYER

Section A. Gross Income

The determination of a business taxpayer's gross income is not radically different from determining the gross income of a non-business taxpayer. The exclusions (gifts, bequests, life insurance proceeds, *etc.*) already examined for the non-business taxpayer are equally available to the taxpayer engaged in business, although the nature of some of the exclusions means that they will ordinarily be of principal interest to non-business taxpayers. This is especially true of bequests and annuities. Gifts to persons or corporations engaged in business are also uncommon, of course, though there are a few cases dealing with subsidies by municipalities and other government agencies to attract or encourage local business. *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950); see *United States* v. *Maryland Jockey Club*, 210 F.2d 367 (4th Cir. 1954); Freeman and Speiller, "Tax Consequences of Subsidies to Induce Business Location," 9 *Tax L. Rev.* 255 (1954). See also §§ 621, 118, and 362(c).

Perhaps the most striking difference between the business and the non-business taxpayer in calculating gross income lies in accounting methods. Non-business income is almost always reported on the cash receipts and disbursements basis—that is, income is reported only as cash or its equivalent is received, and deductions are taken as the taxpayer pays cash or property. On the other hand, the gross income of a business (whether carried on by an individual, a partnership, or a corporation) is often calculated on the accrual basis: income is reported as the customers are charged for goods or services rather than when they pay, and expenses are deducted as obligations are incurred, even though payment is postponed. Moreover, if the business carries inventories of any size, it must take account of its inventories at the beginning and at the end of the taxable year in ascertaining gross income. See § 471. The use of inventories has the effect of charging the cost (or other valuation) of goods that are sold against income in the year in which they are disposed of, rather than in the year when they were purchased or manufactured. Both the cash and accrual methods of computing income and the use of inventories will be examined in more detail in Chapter 8.

Section B. Deductions

In Chapter 2 we saw that the taxpayer has been authorized by Congress to deduct certain of his expenses whether they were incurred in the pursuit of income

or not. Thus the taxpayer can deduct medical expenses, charitable contributions, interest, taxes, and bad debts, for example, even when they are exclusively personal expenses. But the bulk of personal expenses—food, clothing, and rent; wine, women, and song—are not deductible.

Now we turn to an area in which Congress has chosen to allow the deduction of substantially all expenses: those incurred in the taxpayer's trade or business or in his profit-seeking transactions. Unlike the cost of living, then, the cost of *earning* a living is ordinarily fully deductible. If Congress had chosen instead to deny or narrowly restrict the deductibility of *business* expenses, it would have imposed a sales or gross receipts tax rather than an income tax. This would have been constitutional, *supra*, p. 64, but its impact would have been very different from the income tax. What we do have is an income—more exactly, a *net* income—tax.

The statutory framework for allowing the cost of making a living to be deducted consists primarily of these three provisions:

(1) *Section 162(a)*, authorizing the deduction of all the ordinary and necessary *expenses* paid or incurred during the taxable year in carrying on any trade or business.

(2) *Section 212*, authorizing, in the case of an individual, the deduction of all the ordinary and necessary *expenses* paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

(3) *Section 165(a)*, authorizing the deduction of any *losses* sustained during the taxable year and not compensated for by insurance or otherwise. In the case of an individual, Section 165(c) restricts the deduction of losses to those incurred in trade or business or in a transaction entered into for profit.*

These statutory provisions, and others that are less fundamental, will be examined in this chapter. A historical note may first be in order.

Section 212—allowing an individual (including trusts, estates, and partners) to deduct the expenses of producing or collecting income or of managing, conserving, or maintaining property held for the production of income—was enacted in 1942. Previously, Section 23(a) of the 1939 Code (now § 162(a) of the 1954 Code) had permitted only the expenses of "carrying on any trade or business" to be deducted. In 1941, the Supreme Court upheld a decision of the Board of Tax Appeals that this phrase was not broad enough to cover the expenses of a wealthy investor who lived in Paris but maintained an office and staff in New York City (at an expense of $16,000 in one year and $20,000 in another) to manage under his own direction his investments in stocks and bonds. *Higgins* v. *Commissioner*, 312 U.S. 212 (1941). Section 23(e)(2) of the 1939 Code (see § 165(c)(2) of the 1954 Code), however, had for many years allowed an individual to deduct *losses* incurred "in any transaction entered into for profit," even though not connected with a trade or business. Higgins, then, could have deducted any *loss* on the sale of his securities, even though he could not deduct the *expense* of investment advice, safe deposit rental, and bookkeeping service related to the same securities. More-

* Section 165(c) also permits the deduction of casualty losses, even though unconnected with trade or business or transactions for profits. *Supra*, p. 180.

over, it was admitted by the Treasury that Higgins' *real estate* activities *did* constitute a trade or business, so that the expenses of those activities were deductible, and it has since been held that ownership of any rental property constitutes a trade or business, no matter what the taxpayer's main occupation is. *Infra,* Chapter 5, Sec. C. Since only the *net* income from renting real estate was taxable, it was not surprising that Congress decided to tax only the *net* income from investing (or speculating) in stocks or bonds or from other profit-seeking activities. Section 212 was the result.

Section 212 applies only "in the case of an individual." A similar statutory change was not required for corporations, since corporate expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income were presumably already deductible as expenses of the corporation's trade or business. *All* profit-seeking activities of a corporation, in other words, are within the phrase "trade or business." This is not to say that a corporation's expenses are necessarily deductible: they are not. A corporation may own property for the convenience of its stockholders rather than to make money. See, for example, *Savarona Ship Corp.* v. *Commissioner,* ¶ 42,596 P-H Memo TC, involving a yacht, and *Black Dome Corp.* v. *Commissioner,* ¶ 46,130 P-H Memo TC, involving a country estate. When the corporatin's activities are profit-directed, however, § 162(a) is board enough to accomplish what it required both §§ 162(a) and 212 to accomplish for individuals.

The issues that arise under §§ 162(a), 165, and 212—the principal business expense and loss sections—are considered in the pages that immediately follow. Thereafter, certain other business deductions are studied.

1. *Business Expenses and Losses*

> *Note:* Section 162(a) of the 1954 Code, relating to trade and business expenses, was formerly § 23(a)(1)(A).
>
> Section 212, relating to an individual's expenses for the production of income, was formerly § 23(a)(2).
>
> Section 165(a) and 165(c), relating to losses, were derived from §§ 23(f), 23(e)(1), and 23(e)(2).
>
> Section 262, relating to personal, living, and family expenses, was formerly § 24(a)(1).
>
> No substantive changes were made by any of these sections.
>
> See Regs. 118, Secs. 39.23(a), 39.23(e), 39.23(f), and 39.24(a)-1.

The issues that arise under these sections have been grouped together in the following pages under these heads·

(a) Was the expense or loss incurred in business or profit-seeking, on the one hand, or in the pursuit of pleasure, on the other?

(b) Did the taxpayer incur an expense or loss, or did he make a capital investment?

(c) Was the expense, if there was one, "ordinary and necessary? "

These compartments are not watertight, but they are satisfactory if one does not put too much pressure on them.

(a) Business or pleasure?

SMITH v. COMMISSIONER
Board of Tax Appeals, 1939
40 B.T.A. 1038

OPPER: Respondent determined a deficiency of $23.62 in petitioner's 1937 income tax. This was due to the disallowance of a deduction claimed by petitioners, who are husband and wife, for sums spent by the wife in employing nursemaids to care for petitioners' young child, the wife, as well as the husband, being employed. The facts have all been stipulated and are hereby found accordingly.

Petitioners would have us apply the "but for" test. They propose that but for the nurses the wife could not leave her child; but for the freedom so secured she could not pursue her gainful labors; and but for them there would be no income and no tax. This thought evokes an array of interesting possibilities. The fee to the doctor, but for whose healing service the earner of the family income could not leave his sickbed; the cost of the laborer's raiment, for how can the world proceed about its business unclothed, the very home which gives us shelter and rest and the food which provides energy, might all by an extension of the same proposition be construed as necessary to the operation of business and to the creation of income. Yet these are the very essence of those "personal" expenses the deductibility of which is expressly denied. I.R.C., Sec. 24(a)(1).

We are told that the working wife is a new phenomenon. This is relied on to account for the apparent inconsistency that the expenses in issue are now a commonplace, yet have not been the subject of legislation, ruling, or adjudicated controversy. But if that is true it becomes all the more necessary to apply accepted principles to the novel facts We are not prepared to say that the care of children, like similar aspects of family and household life, is other than a personal concern. The wife's services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal and not susceptible of deduction. *Rosa E. Burkhart*, 11 B.T.A. 275. Here the wife has chosen to employ others to discharge her domestic function and the services she performs are rendered outside the home. They are a source of actual income and taxable as such. But that does not deprive the same work performed by others of its personal character nor furnish a reason why its cost should be treated as an offset in the guise of a deductible item.

We are not unmindful that, as petitioners suggest, certain disbursements normally personal may become deductible by reason of their intimate connection with an occupation carried on for profit. In this category fall entertainment, *Blackmer v. Commissioner*, 70 Fed.(2d) 255 (C.C.A. 2d Cir.) and traveling expenses, *Joseph W. Powell*, 34 B.T.A. 655; affd., 94 Fed. (2d) 483 (C.C.A., 1st Cir.), and the cost of an actor's wardrobe, *Charles Hutchison*, 13 B.T.A. 1187. The line is not always an easy one to draw nor the test simple to apply. But we think its principle is clear. It may for practical purposes be said to constitute a distinction between those activities which, as a matter of common acceptance and universal experience, are "ordinary" or usual as the direct accompaniment of business pursuits, on the

one hand; and those which, though they may in some indirect and tenuous degree relate to the circumstances of a profitable occupation, are nevertheless personal in their nature, of a character applicable to human beings generally, and which exist on that plane regardless of the occupation, though not necessarily of the station in life, of the individuals concerned. See *Welch* v. *Helvering*, 290 U.S. 111.

In the latter category, we think, fall payments made to servants or others occupied in looking to the personal wants of their employers. *David Sonenblick*, 4 B.T.A. 986. And we include in this group nursemaids retained to care for infant children.

Note

1. This holding was recently reaffirmed, *O'Connor* v. *Commissioner*, 6 T.C. 323 (1946). If a husband's net income is $10,000, and his wife has an opportunity to earn $3,000, the additional tax (at 1954 rates and assuming two dependent children) will be about $750. Domestic help and other expenses can of course easily take the lion's share of what is left. If the husband's income is $35,000, more than half of the wife's earnings will be consumed by taxes Is the case of the working wife different from that of the small town lawyer who moves to the big city, and makes more in cash, but spends it on maintaining his new station in life?

A measure of relief is extended by § 214, added by the 1954 Code, which allows a deduction (not to exceed $600) for the expenses of caring for children under 12 and for certain other dependents "for the purpose of enabling the taxpayer to be gainfully employed" The deduction is allowed only to women and widowers. In the case of a working wife, a joint return with her husband must be filed, and the deduction is to be reduced (unless the husband is incapable of self-support because mentally or physically defective) by the amount by which their adjusted gross income exceeds $4,500. Note § 214(b)(1)(B), neighbors can get the deduction if they employ each other's teen-age children to baby-sit, but not if they employ their own children. Must the expenses be for care during working hours?

2. Somewhat analogous decisions are *Hubbart* v. *Commissioner*, 4 T.C. 121 (1944), holding the expense of travelling between house and office to be personal, and *Bruton* v. *Commissioner*, 9 T.C. 882 (1947), denying the deduction of taxi fares paid by a partially paralyzed lawyer to get from his home to his office. Is the expense of curing a disease incurred in the course of employment deductible? See *supra*, p. 165.

3. Another commonly encountered issue is the deductibility of uniforms and work clothing. Note that Regs. 118, Sec. 39.24(a)-1, though restricted to Army officers, seems to suggest that the cost of a uniform cannot be deducted if it takes the place of civilian clothing. Despite this, the Bureau has ruled that clothing that must be worn as a condition of employment and that is not suited for off-duty wear (*e.g.*, the uniforms of police officers, nurses, *etc.*) can be deducted. Mim. 6463, 50-1 C.B. 29. Special boots, gloves, protective clothing, and the like are also deductible, but not work clothes that can be worn off duty and are not required by the employer. *Roth* v. *Commissioner*, 17 T.C. 1450, 1455 (1952). See Comment, Income Tax. Deductibility of Uniform and Clothing Expenses by Employees, 36 *Calif. L. Rev.* 452 (1948).

4. In *Howard* v. *Commissioner*, 202 F.2d 28 (9th Cir. 1953), an army officer was allowed to deduct the expense of defending himself in a court martial, the charge being conduct unbecoming an officer, *viz.*, failing to pay alimony to his ex-wife. Did the court accept the "but for" argument—but for the expense of defending himself, he might have been convicted and thus might have lost his right to engage in his chosen occupation? Would the expense of successfully defending himself in a criminal case be a business expense because conviction might have been followed by a court martial and discharge from the service? In I.T. 3551, 42-1 C.B. 42, the Bureau ruled that the expense incurred by a government official in defending himself against charges under the Hatch Act (prohibiting political activities by government employees) was not

a business expense, apparently because the acts that stimulated the charges were not part of his official duties. See *Salt* v. *Commissioner, infra*, p. 249.

SCHULZ v. COMMISSIONER

Tax Court of the U. S., 1951
16 T.C. 401

ARUNDELL, Judge: The respondent has disallowed as a deduction from the petitioner's 1945 taxable income the sum of $9,304.40 claimed as entertainment expense, and a $400 item claimed as advertising expense. There is no serious dispute as to whether either of these sums was spent; the issue is whether they are deductible.

Entertainment expenses are allowed as a deduction from gross income only to the extent that they are "ordinary and necessary" in carrying on a trade or business. Section 23(a)(1) of the Internal Revenue Code. The requirements that the expense must be both ordinary and necessary must be strictly complied with, *Helvering* v. *Welch*, 290 U.S. 111, and whether contested expenditures are ordinary and necessary is primarily a question of fact. *Commissioner* v. *Heininger*, 320 U.S. 467. Proof is required that the purpose of the expenditure was primarily business rather than social or personal, and that the business in which taxpayer is engaged benefited or was intended to be benefited thereby. *Louis Boehm*, 35 B.T.A. 1106.

During 1945 petitioner elaborately entertained buyers and others connected with the jewelry business, personally spending about $7,000. In addition thereto approximately $2,000 was expended by his wife and employees on luncheons, drinks, weekend visits, conventions, suppers, theaters, and nightclubs. Approximately $3,400 of the $7,000 expended by petitioner personally was spent on suppers, theaters, and nightclubs and other forms of evening entertainment. On these occasions petitioner would bring his wife and the party or parties he was entertaining would also bring their wives. There is little to distinguish these occasions from the usual social gatherings among friends to renew acquaintanceship and enjoy a pleasant evening. They bear little semblance to the usual gatherings of business people at restaurants or other places of entertainment which serve primarily as congenial meeting places for the discussion or negotiation of business matters. Petitioner made no attempt to show that the evening entertainment he offered his guests served this purpose or that all of it was directly related to the operations of his business.

These gatherings may have been desirable and helpful to the present and future success of petitioner's business, but this is usually true of all entertaining done by business or professional people for the purpose of acquiring or retaining the favor of patrons and clients. Such expenditures are nonetheless nondeductible absent a showing that they were ordinary and necessary to the taxpayer's business within the meaning of section 23 of the Internal Revenue Code. In *Louis Boehm, supra*, we stated:

> We do not think the burden of proof is met by the petitioner's argument that in general, membership in social, political, and fraternal organizations is helpful in obtaining clients through contacts made thereby or the citing of one instance of gaining a client through acquaintance made at a political club. No evidence has been introduced to show that

any part or all of the expenditures in question were so closely related to the conduct of the petitioner's business as to have been appropriate, helpful, usual, or necessary. It is noted that in cases where expenditures of a social nature have been held to be deductible business expenses proof was presented to show that such expenditures had a direct relation to the conduct of a business or the business benefits expected. Such proof has not been presented here to show that the expenditures are deductible under section 23(a).

After taking into consideration the nature of the entertainment provided by the petitioner and the fact that it was undertaken at a time when he had more business than he could handle, we are not convinced that all of the expenditures in issue were made for purely business reasons or that the entire cost of such entertainment may be characterized as ordinary and necessary expense incident to the carrying on of the petitioner's business. An expense is deductible only if it complies with the strict requirements of section 23 and does not constitute a personal expense expressly disallowed by section 24.

Moreover, the petitioner's attempt to deduct such nondeductible items as the cost of repairing an automobile, the cost of hotel rooms, tips, and meals on two occasions when, after a night of entertaining customers, he remained in New York after missing the train home, and the inclusion of $200 which had been placed in the petty cash fund but was not expended on entertainment, all create doubt as to the accuracy of the total deduction.

On the other hand, we are convinced that some part of the expenditures was prompted by strictly business considerations and should be characterized as ordinary and necessary expenses. Applying the rule of *Cohan* v. *Commissioner*, 39 Fed.(2d) 540, we have reached an approximation after a careful consideration of the testimony of petitioner and his wife and a close examination of the memoranda and other exhibits received in evidence. From all this evidence, we have concluded that $5,500 fairly represents the amount spent by the petitioner for ordinary and necessary business entertainment in 1945 and that amount is properly deductible under section 23(a)(1) of the Internal Revenue Code.

The petitioner has included in his advertising expense the sum of $400 spent in entering his horse named "Schulztime" in a horse show and for such items as horse show programs and trophies. Petitioner has not satisfactorily shown how these expenditures were calculated to advertise or publicize his business. There is no evidence that the petitioner called the attention of those persons attending the horse shows to the fact that he was a dealer in watches by advertising in the horse show program. *Cf. Rodgers Dairy Co.*, 14 T.C. 66. There is an inference in the record that the name "Schulztime" was relied on by petitioner to publicize his business but if this be true the name chosen was so subtle and the entry of a horse in a show so far removed from the petitioner's business that it could not reasonably have been expected to publicize the business. In our opinion, the $400 so expended was not an ordinary and necessary business expense within the meaning of section 23(a)(1) of the Code and the Commissioner's disallowance of the deduction is sustained.

Note

1. In *Sutter* v. *Commissioner*, 21 T.C. 170, 173 (1953), the Court spoke of:

the stubborn thread of a single problem which has never apparently been squarely and expressly passed upon. . . . When a taxpayer in the course of supplying food

or entertainment or making other outlays customarily regarded as ordinary and necessary includes an amount attributable to himself or his family such as the payment for his own meals, is that portion of the expenditure an ordinary and necessary business expense on the one hand or a nondeductible personal item on the other? .... [W]e think the presumptive nondeductibility of personal expenses may be overcome only by clear and detailed evidence as to each instance that the expenditure in question was different from or in excess of that which would have been made for the taxpayer's personal purposes.

2. In the *Cohan* case, cited by the court, Judge L. Hand wrote:

In the production of his plays [George M.] Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer, whose inexactitude is of his own making. [39 F.2d 540, 543-44 (2d Cir. 1930).]

No doubt in some of the cases in which the taxpayer is allowed only part of his claim under the *Cohan* case for want of substantiation, the decision penalizes lack of records or failure to prove the business connection of *bona fide* expenses; in others, however, it may be a reward for exaggerated claims which could never have been substantiated. See generally Gluck, "How *Cohan* Works. Allowance of Business Expense Deductions When No Exact Records Are Kept," 6 *Rutgers L. Rev.* 375 (1952).

3. After an extended investigation of the Bureau of Internal Revenue in 1951 and 1952, a subcommittee of the House Committee on Ways and Means, headed by Congressman Cecil R. King, reported:

A second way to reduce possible corrupt practices in the Bureau is to minimize the opportunities and temptation. For example, under a leading judicial decision, a taxpayer who claims large business deductions but has not kept any records to substantiate the claim is entitled to a reasonable allowance for the claimed expenses, which must be estimated by the Revenue Agent. Stricter requirements for keeping of reasonably detailed records by taxpayers would eliminate the necessity for discretionary determination of the proper expense deduction, and with it, any possible temptation for the Revenue Agent to allow an improperly large deduction in exchange for some private benefit extended to him by the taxpayer.

This record-keeping proposal, aside from its tendency to eliminate opportunities for corruption in the Bureau, should reduce the risk that the great multitude of taxpayers who have no substantial business deductions may feel that some persons having such opportunity to claim deductions are not paying their fair share of taxes....

Recent high tax rates have resulted in attempts by some business organizations to reward key personnel with tax-free personal benefits. These may take the form of free automobiles, airplanes, vacations, housing, or servants, all theoretically for the benefit of the employer. Of like character is the practice of allowing overly liberal expense accounts to employees whose duties involve travel or business entertainment, sometimes the employer may tolerate padding of the expense account by the employee as a way of giving him tax-free income. The opportunity for a limited segment of the taxpaying population to receive such tax-free benefits jeopardizes

> public confidence in the impartial imposition of taxes. As a basis for possible legislation, the subcommittee recommends that definite information be obtained as to the prevalence of these practices and as to the amount of revenue lost thereby. Your subcommittee has been advised that the Treasury Department will obtain these statistics and report to the Congress on the problem. (*Report to House Committee on Ways and Means,* Subcommittee on Administration of the Internal Revenue Laws (1952) 29.)

See Rev. Rul. 54-195, 54-1 C.B. —, containing instructions to internal revenue agents on the degree of proof required for traveling and entertainment expenses.

See Havemann, "The Expense Account Aristocracy," *Life,* March 9, 1953, reporting:

> In cities like New York, Washington and Chicago it is safe to say that at any given moment well over half of all the people in the best hotels, the best nightclubs and the best restaurants are charging the bill as an expense account item to their companies, which in turn are charging it to the government in the form of tax deductions.

In "Europe's Lighter Side," in the New York Herald-Tribune (July 20, 1954), Art Buchwald reported that many Europeans had been puzzled by promising business deals that, after being discussed with them by vacationing Americans, had never been closed He states:

> The only way we've been able to appease the Europeans is to explain that the Americans weren't being malicious. They were just trying to deduct their trip from their income tax. After it's explained, the European is always mollified. If there's one thing a European understands, it's tax evasion

4. Whether an abuse of the "expense account" will be discovered on audit depends to a considerable degree on the manner in which the deductions are reported. If an employee receives a salary to cover both his services and his expenses, his individual return will reflect the full amount received by him (which can be quickly compared with Form W-2, the employee's withholding statement), and any deductions he takes will be set out in his return, and may invite inquiry. On the other hand, if the employer pays a smaller salary, and defrays the expenses itself by direct payment to the restaurant, garage, *etc.*, the expenses will be buried in a vast mass of business deductions where their personal character may not be apparent upon audit. If the employer pays a salary for services plus a flat sum for expenses, the latter should be reported as income by the employee, and his deductions should be itemized; moreover, the allowance should be reported by the employer on Form 1099. Regs 118, Secs. 23(a)–2(d) and 147–2(a) Reimbursement for actual expenses should be treated in the same way as a *per diem* or other allowance: the receipt is reported as income and the expenses are deducted.

5. Where the taxpayer is an employee, claimed entertainment expenses may be disallowed because they were paid in carrying on his employer's, rather than his own, trade or business. An example is *Roach* v. *Commissioner,* 20 B.T.A. 919(1930) (where the dichotomy was especially formal because the taxpayer and his wife owned all the stock of the corporation by which he was employed), recently applied in *Jergens* v. *Commissioner,* 17 T.C. 806 (1951). This barrier can be hurdled by the taxpayer who shows that part of *his* job is the entertainment, at his own expense, of his employer's customers. In *Henricks* v. *Commissioner,* ¶ 49,268 P-H Memo TC, the taxpayer, an advertising solicitor for Time, Inc., was able to rely upon a memorandum from his employer stating:

> Mr. Luce and other Management officers have often emphasized that TIME salesmen are paid high salaries because selling is not a routine job and makes demands on a man's time and money that cannot be accounted for minute-by-minute or penny-by-penny. There are many expenses incidental to selling which the salesman is not expected to recover from the Company on top of his salary.

Often, however, less formal evidence of the employee's obligation to pay some ex-

penses himself is sufficient. See, *e.g.*, *Schmidlapp* v. *Commissioner*, 96 F.2d 680 (2d Cir. 1938).

This rule—permitting a deduction to be taken only if the expense or other item is the taxpayer's own—has been encountered previously, *Holden* v. *Commissioner*, *supra*, p. 176, and it is of general applicability. See Note, Deductibility of Expenses Incurred for the Benefit of Another, 66 *Harv. L. Rev.* 1508 (1953).

SMITH v. COMMISSIONER

Tax Court of the U. S., 1947
9 T.C. 1150

Hill, Judge: The question is whether petitioner operated the farm as a trade or business or for profit, on the one hand, or for recreational purposes or as a hobby, on the other. As is implicit or stated in the cases cited by both petitioner and respondent, the answer to this question lies in determining petitioner's intention from all of the evidence. We have concluded that the facts show that the petitioner's intent in operating the farm was primarily for the purpose of making a profit.

Respondent bases his argument that petitioner had no intent to operate the farm as a trade or business or for profit on the following points: (1) That the operation of the farm resulted in a series of uninterrupted losses, (2) that petitioner's purchase of the farm was essentially motivated by his desire to have a country estate for his home, and (3) that petitioner operated the farm in order to supply his family with food for home consumption.

It is true that the petitioner has experienced continuous annual losses from the operation of his farm since its acquisition in 1933 and through the taxable years in question. Moreover, the record discloses that after the taxable years involved here there were further losses in 1944, 1945, and 1946. The fact that the operation of the farm has resulted in a series of losses, however, is not controlling if the other evidence shows there is a true intention of eventually making a profit. See *Israel O. Blake*, 38 B.T.A. 1457. Respondent cites the case of *Thacher* v. *Lowe*, 282 Fed. 1944, to support his argument. The court in that case stated:

> . . . it is difficult to imagine how a farm which has been running the number of years which this had could be thought capable of turning a deficiency of 90 per cent into a profit.

On the facts in the instant case, however, we can not say that there is no reasonable expectation of realizing a profit.

We do not agree with the respondent that petitioner purchased the farm primarily to satisfy his desire to live on a country estate. It may be true that petitioner experienced pleasure from residing in a country home, but this fact alone does not negative his intent to operate the farm for profit. *Wilson* v. *Eisner*, 282 Fed. 38. Nor is such intent negatived by the fact assumed by respondent that petitioner, as a business executive, has received an annual salary sufficiently high to indicate no need to supplement his income by the farm operation.

We are convinced from the record that it has at all times been petitioner's intention to operate the farm for profit, and that he had reasonable expectations of accomplishing that result. His efforts to make a profit have included increasing the land in cultivation and in pasturage from 75 to 95 acres, renting the farm, em-

ploying an experienced farmer to operate it under his supervision, improving the land by reclamation practices and fertilization and soil conservation methods, and engaging at various times in a number of diversified types of farming. He spends most of his week ends working on the farm, performing such odd jobs as repairing buildings or equipment, feeding poultry, and spraying orchards. On week days he usually consults with his employee for 10 or 15 minutes each morning in connection with problems related to the operation of the farm. In addition he has expended a great deal of money in repairing farm buildings and buying farm equipment, all of which was for utilitarian rather than beautification purposes. He has always considered the farm separate from his home, he has segregated the capital and operating expenses of the residence from the farm expenses, and he has not used the farm for any social or recreational purposes, nor does it have any such facilities.

This leaves for our consideration respondent's argument that petitioner operated the farm primarily for the purpose of providing wholesome food for his family. It should be noted, first, that petitioner and his family consumed at the most only 10 per cent of the farm products on the average and that all of those used were included and reported in the farm income at regular prices. The other approximately 90 per cent of the farm produce was sold by the petitioner to local butchers and grocerymen, to purchasers stopping by the farm, and occasionally to the Delaware Packing Co. at Trenton. In addition to that, the types of products raised by petitioner included poultry, eggs, cattle, sheep, wheat, corn and hay, many of which are not readily adaptable to home consumption, and such of them as were so adaptable were produced in far greater quantities than his home consumption requirements. The petitioner's primary intention, therefore, was not to produce good food for home consumption. Consequently, the case of *Louise Cheney*, 22 B.T.A. 672, cited by respondent, is not in point.

We hold that petitioner's farm operations during the taxable period here involved were a business regularly carried on by him for profit and that the losses in question resulted from ordinary and necessary expenses paid during such taxable period in carrying on such business and, therefore, are deductible for income tax purposes.

Note

1. Commenting on the country estate and racing stable cases, Randolph Paul has said:

> The American business man has never appeared so indefatigably optimistic as in some of the cases on this point; taxpayers have earnestly contended (sometimes successfully) that they expected to reap an ultimate profit even though operating losses exceeded receipts with depressing regularity over a long period of years. Paul, Motive and Intent in Federal Tax Law, in *Selected Studies in Federal Taxation* (Second Series, 1938) 281–2.

Horse breeding and racing, though the sports of kings, have been held in a surprising number of cases to be the business of taxpayers. See, for example, *Commissioner* v. *Widener*, 33 F.2d 833 (3d Cir. 1929) (losses of more than $300,000 in four years); *Whitney* v. *Commissioner*, 73 F.2d 589 (3d Cir. 1934); *Farish* v. *Commissioner*, 103 F.2d 63 (5th Cir. 1939). In the last case, the possibility of geographical and occupational discrimination was suggested:

> The intention of the taxpayer at the outset is the dominant factor in determining whether he engaged in the venture merely for pleasure or for profit. Of course, the Board could rest its decision on the circumstantial evidence, as opposed to the sworn testimony of the taxpayer. But we think the Board was psychologically wrong in concluding that the Farishes, as men of sound business judgment, would not have engaged in the ventures with any expectation of profit. Both are actively engaged in the oil business. It is common for a man in the oil business, of sound judgment, to expend thousands of dollars in exploring the land and drilling for oil in "wild cat" territory. Sometimes this results in dry holes and the costs of drilling and development are totally lost. On other occasions, producing wells are brought in and the profits are enormous. The breeding of horses would not be considered merely a fad in Texas. It is not at all improbable that men in the oil business, having ample capital, would engage in the enterprises here involved with the hope and expectation of ultimately making a fair return on the investment. [103 F.2d at 65.]

By accident or not, gentlemen authors, though they lose money as regularly as gentlemen farmers, have apparently been less successful in proving their acquisitive intentions. *Chaloner* v. *Helvering*, 69 F.2d 571 (C.A.D.C. 1934); *Purdy* v. *Commissioner*, 12 T.C. 888 (1949). See also *Ewing* v. *Commissioner*, —F.2d—(2d Cir. 1954). In *Hempel* v. *Commissioner*, ¶ 47,183 P-H Memo TC, a formerly successful concert singer seeking to make a come-back was held to be engaged in a trade or business although she claimed expenses of $10,000–$15,000 annually for 12 years with only nominal earnings, the Tax Court rejected the Treasury's uncharitable argument that the expenses were personal expenses to continue "the illusion of a famous prima donna who could not bear to slip out of the public eye."

2. What are the prospects for a collector of art, rare books, or postage stamps who claims a deduction under § 165(c)(2) on the ground that though he enjoyed looking at his collection, his primary aim was to build up a hedge against inflation or eventually to sell at a profit?

3. Even if the taxpayer succeeds in establishing that he is engaged in a trade or business, § 270 denies him the right to deduct more than $50,000 from his other income (salary, interest, dividends, *etc.*) if the trade or business in question results in losses of $50,000 or more each year for five consecutive years. The statute of limitations is extended so as to permit the Commissioner to recompute the tax for earlier years after the trade or business has produced the required series of loss years.

4. If the activity is held to be a hobby instead of a trade or business, can the Commissioner tax the gross income therefrom without allowing the taxpayer to deduct any of the related expenses?

5. Note § 165(d). It has been held (by a divided court) that by virtue of this section wagering losses are deductible to the extent of wagering gains, whether or not the losses were incurred in transactions qualifying under § 165(c)(2). *Humphrey* v. *Commissioner*, 162 F.2d 853 (5th Cir. 1947). Ordinarily, of course, the gambling taxpayer has a profit-seeking motive. But what if he is a tourist in Las Vegas, looking only for excitement and convinced that he will lose?

6. Section 162(b) is designed to prevent avoidance of the percentage limits imposed by § 170(b) on deductions for charitable contributions by a claim that the gifts were business expenses. But if the taxpayer is able to show that the payment to the charitable organization was not a "contribution or gift," it may be deducted as a business expense. For an example, see Regs. 118, Sec. 39.23(a)–13. Presumably moderately selfish motives (such as the desire to improve employee morale or to build good will) are not enough; the payment must be motivated by direct business advantages. The prohibition of § 162(b) is also inapplicable if the organization, though having a charitable purpose, does not meet the requirements of § 170(b). See *B. Manischewitz Co.* v. *Commissioner*, 10 T.C. 1139 (1948); I.T. 3580, 1942–2 C.B. 95. Before 1954, § 162(b) was applicable only to corporations, the 1954 Code extended it to individuals as well.

GEVIRTZ v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1941
123 F.2d 707

Before SWAN, CHASE, and FRANK, Circuit Judges.

FRANK, Circuit Judge.

Taxpayer, a woman of considerable wealth, was, for some years prior to 1926, a resident of Mt. Vernon, where, at one time, she had built and later sold a garden apartment house. Conceiving the idea of constructing another garden apartment, she purchased a tract of several acres with this in view, but she became dissatisfied with the location and sold it in 1925. Shortly thereafter she advised a real estate agent at Mt. Vernon that she was interested in acquiring another tract of land upon which to build an apartment house. Early in 1926 she purchased a one-acre parcel for $32,000, paying $7,000 in cash and giving back a mortgage for $25,000. The deed contained restrictions, providing that no building could be erected on the premises for any trade, calling, or business whatever, the premises being restricted to dwelling purposes by means of homes for use or value of not less than $15,000, and built not more than one to each 75 feet of frontage, and that no building erected on the land could be used as a tenement house or apartment house. At the time of the hearing of the present proceeding by the Board, these restrictions had not been removed, although it was believed, we may assume with good reason, that they could be. Immediately following the acquisition of this property, the taxpayer learned, for the first time, that several large apartment house projects were being contemplated in Mt. Vernon, some of them not far distant from the property in question. She then decided that it would be a mistake to proceed with any plans to build an apartment house on that site, since the other projected apartment houses were more than sufficient to satisfy the demand and there would be difficulty in securing tenants at profitable rental rates.

She then erected on the property a 12-room residence costing in excess of $90,000. On the advice of her real estate agent, this residence was constructed with three separate wings, each of which could be made into a separate apartment with its own private entrance and driveway, so that the building could be converted into a 3-family dwelling. She knew at that time that it could not be rented at a profit as a private residence She lived in it from the time of its completion in 1926 until December 31, 1931. She then vacated it and endeavored to sell or rent it, but without success. In November or December, 1934, she discharged the caretaker whom she had left in charge of the property and turned the keys to the house over to the attorneys for the original mortgagees with the request that she be released from personal liability on the bond and mortgage. In the last week of 1934, those attorneys informed her that she would not be thus released, as the mortgagees wished to foreclose, although they expressed the opinion that there would be no deficiency judgment against the taxpayer as the mortgagees thought that the market value of the property was in excess of the amount of bond and mortgage. In the taxpayer's income tax return for the calendar year 1934 she claimed, on the basis of the foregoing, a deductible loss from gross income of $89,588.80 and also deductions for depreciation, cost of insurance and legal ex-

penses. The Commissioner disallowed these deductions and the Board, after hearing, sustained the deficiency as determined by the Commissioner. The taxpayer petitioned this court for review.

Taxpayer is entitled to a deduction only for a loss incurred in a "transaction entered into for profit," I.R.C., Sec. 23(e)(2). The evidence amply supports the finding of the Board that there was a "definite abandonment" by the taxpayer of her original profit motive in purchasing the land and a "definite devotion of the property to a personal residence use." The fact that the residence cost $90,000, coupled with the other facts found by the Board, answers the suggestion that the construction of the residence with three separate wings, so that it could, at some indefinite future date, be converted into three separate apartments, showed a retention of the original business purpose. That the taxpayer had in mind the possibility of later devoting the property to such a purpose is not sufficient to demonstrate that the profit motive remained dominant. Cases can be imagined where a taxpayer's motive might be mixed, with the profit motive so markedly preponderant that it should be regarded as if it were controlling. But that is not this case. Here the prospect of a future business use of the property was clearly subsidiary, only on the edge of the taxpayer's mind. Her attitude was not unlike that of the White Knight who carried a mouse-trap on his horse because, he said, "it's well to be provided for everything." At best, it was as if she had bought a residence for her personal use, intending to live in it for several years and then put it on the market.

Once the conclusion is reached that when the residence was built she did not have a business purpose, the case falls into a familiar category. There was no subsequent conversion of the property to a business use; the mere effort to rent it did not have that effect. *Morgan* v. *Commissioner*, 5 Cir., 76 F.2d 390. The claimed deductions, therefore, constituted items of personal loss and expense which are not deductible.

The judgment of the Board of Tax Appeals is affirmed.

Note

1. With respect to a possible "subsequent conversion of the property to a business use," the Supreme Court in *Heiner* v *Tindle*, 276 U.S. 582, 587 (1928), permitted the taxpayer to deduct under § 165(c)(2) his loss on the sale of a building constructed and used for a time as a residence but subsequently rented for some years:

> The loss here has resulted from the sale of property not used for residential purposes by the taxpayer, and the transaction entered into for profit and resulting in the loss was not the purchase of the property but its appropriation to rental purposes.

The deduction is the difference between (a) the cost of the building or its value when converted to rental purposes, whichever is lower, minus depreciation for the rental period, and (b) the amount realized on the sale. Regs. 118, § 39.23(e)-1, Examples (1) and (2). This means that any decline in value occurring during the period of residential use may not be deducted.

The courts have regularly refused (as in the *Gevirtz* case) to accept the mere listing of the property for rental as a sufficient conversion to satisfy § 165(c)(2); it must be actually rented or remodeled for rental. See, for example, *Rumsey* v. *Commissioner*, 82 F.2d 158, 159-60 (2d Cir. 1936).

The taxpayer argues with considerable persuasive force that the fact that a man

first rents his house before selling it is only significant as evidentiary of his purpose to abandon it as a residence and to devote the property to business uses; that renting is not the sole criterion of such purpose, as the regulations themselves imply by the words "rented or otherwise appropriated" to income producing purposes. But we think the argument cannot prevail over counter considerations. If an owner rents, his decision is irrevocable, at least for the term of the lease; and if he remodels to fit the building for business purposes, he has likewise made it impossible to resume residential uses by a mere change of mind. When, however, he only instructs an agent to sell or rent the property, its change of character remains subject to his unfettered will, he may revoke the agency at any moment. Certainly it strains the language of Article 171, Regulations 74 [now Sec. 39.23(e)-1(e) of Regs. 118], to find that the property is "appropriated to" and "used for" income producing purposes by merely listing it with a broker for sale or rental. Until instructed by the Supreme Court that its decision in *Heiner* v. *Tindle* was intended to have a broader application, we feel constrained to follow the more natural meaning of the regulation.

In *Schmidlapp* v. *Commissioner*, 96 F.2d 680, 682 (2d Cir. 1938), Judge L. Hand wrote:

> As a new matter something may no doubt be said against distinguishing between a house actually let, and one unsuccessfully put upon the market; putting the property in the hands of a broker might perhaps be regarded as itself the inception of a "transaction entered into for profit." But *Morgan* v. *Commissioner*, 5 Cir., 76 F.2d 390, and *Rumsey* v. *Commissioner*, 2 Cir, 82 F.2d 158, are the other way; they hold in effect that only an actual letting creates a "transaction," and it is true that only then does it become impossible for the owner to resume his original occupation.

2. Note that in the *Gevirtz* case, maintenance expenses and depreciation were put on the same footing as the loss on sale of the house, all were disallowed. After the enactment in 1942 of what are now §§ 212 and 167(a)(2), it was held that listing a residence for rent is a sufficient conversion to permit maintenance expenses and depreciation to be deducted under §§ 212 and 167(a)(2), even though it is not a sufficient conversion to permit the deduction of a loss on its sale under § 165(c)(2). The theory is that once the house is listed for rental, it is "held for the production of income" within the meaning of §§ 212 and 167(a)(2), even though there is no "transaction entered into for profit," the term used in § 165(c)(2). *Robinson* v. *Commissioner*, 2 T.C. 305, 308-9(1943); see also *Horrmann* v. *Commissioner*, 17 T.C. 903 (1951). Is listing it for *sale* satisfactory?

3. Suppose the taxpayer sells at a loss a residence acquired by inheritance or gift. Has there been a "transaction entered into for profit" so as to permit deduction of the loss under § 165(c)(2)? Apparently the taxpayer-heir's decision to sell property is sufficient for § 165(c)(2), even though the property was not so held by the decedent; moreover, it has been held that listing the property for rental is enough, so long as the heir has not used it as a residence himself. *Williams, Exec.* v. *Commissioner*, 1 B.T.A. 1101 (1925); *Crawford* v. *Commissioner*, 16 T.C. 678 (1951); see *Horrmann* v. *Commissioner*, 17 T.C. 903, 909–10 (1951). In another case, the disposition of property by an executor was held (by a divided court) to be a "transaction entered into for profit," although the decedent had acquired it for personal reasons and would have been unable to claim a loss had he disposed of it during his lifetime. *Waterman's Estate* v. *Commissioner*, 195 F.2d 244 (2d Cir. 1952). On the other hand, a donee of investment property was held to be entitled to deduct a loss on its sale on the theory that his donor's profit-seeking purpose should be imputed to him. *Tanzer* v. *Commissioner*, 37 B.T.A. 244(1938). The reasoning of the court is somewhat weakened by a subsequent statutory change. Could the donee alternatively assert that his own holding of the property for the production of income would constitute a "transaction entered into for profit"?

4. Is § 165(c)(2) satisfied if the taxpayer incurs the loss by selling the property for

tax purposes? In *Terry* v. *United States*, 10 F. Supp. 183 (D Conn. 1934), it was held that the loss qualified so long as the property was *acquired* in a "transaction entered into for profit." If the *sale* itself had to be such a transaction, the court argued, there could be no loss under § 165(c)(2). But the sale must be bona fide and at arm's length; see *Evans* v. *Rothensies*, 114 F.2d 958 (3d Cir. 1940), holding that property acquired for profit-making purposes will not give rise to a deductible loss if sold at an unnecessarily low price. "The disposition of property as well as its acquisition is material to the question whether the transaction was entered into for profit. . . ." 114 F.2d at 962. On the other hand, a sale below market value, if dictated by business considerations (e g., granting a proprietary interest in a business to its employees), may give rise to a § 165(c)(2) deduction. *Kress* v. *Stanton*, 98 F. Supp. 470 (W.D. Pa. 1951), aff'd. p.c. 196 F.2d 499 (3d Cir. 1952).

5. If after paying premiums on a life insurance policy for a number of years, a taxpayer surrenders or sells it for less than the premiums already paid, does he have a deductible loss from a "transaction entered into for profit?" See *London Shoe Co.* v. *Commissioner*, 80 F.2d 230 (2d Cir.), cert. den. 298 U.S. 663 (1935); *Early* v. *Atkinson*, 175 F.2d 118 (4th Cir. 1949).

BAER v. COMMISSIONER

U. S. Court of Appeals, Eighth Circuit, 1952
196 F.2d 646

Before. GARDNER, Chief Judge, and WOODROUGH and THOMAS, Circuit Judges.

GARDNER, Chief Judge:

This matter is before us on petition to review a decision of the Tax Court which sustained a finding of deficiency in petitioner's income tax return for the year of 1947 in the amount of $78,633.12. The deficiency resulted from disallowance of deductions from taxpayer's income of an item of $35,000 paid by taxpayer to his divorced wife pursuant to a property settlement, and an item of $20,000 paid to her attorney for legal fees in connection with the divorce proceedings, and an item of $16,500 paid to his own attorneys for legal fees in connection with the divorce proceedings. [The only issue in the portion of the case here reprinted is whether the payment by the taxpayer to his attorneys was deductible under § 23(a)(2) of the 1939 Code, now § 212 of the 1954 Code] The findings of the Tax Court are not challenged and may be summarized as follows:

Petitioner, a resident of St. Louis, Missouri, was married to Mary E. Baer July 27, 1936. They had one child, Mary Ann Baer, who in 1946 was about nine years old. On December 14, 1946, Mrs. Baer filed suit for divorce, and asked for alimony, custody and support of the minor child, and other relief. In that proceeding she alleged that her husband had property of several millions of dollars. While the suit for divorce was pending, on July 10, 1947, the parties executed an agreement settling their property rights and on the same date a decree of divorce in favor of Mrs. Baer was entered. . . .

Petitioner and his wife and their attorneys were negotiating from about September, 1946, until about July 10, 1947, relative to the marital rights and obligations of petitioner and his wife. At first a reconciliation was attempted but appeared hopeless and thereafter most of the negotiations were directed to the financial aspects of the matter. . . .

It was claimed by counsel for Mrs. Baer that petitioner's estate exceeded in value $6,000,000, and she made demand for payment in excess of $1,000,000 in a lump

sum. His estate consisted largely of stock of the Stix, Baer and Fuller Company and his income came mainly from the salary paid him by that company as its president and dividends received by him from that company. It was of very great importance to him to maintain in specie his stock in this company so as to retain control, which may well have meant his salary and to a certain extent the earnings of the company. The demand for $1,000,000 in a lump sum could not have been met by him without a sale of a very considerable amount of his stock in this company. It was, of course, conceded that if Mrs. Baer were granted a divorce she would be entitled to a very large sum in alimony. The controversy did not go to the question of the liability but to the manner in which it might be met by the petitioner without greatly disturbing his financial structure. It was of the utmost importance to him to maintain his control of the company and thus his stock therein which was a producer of income, and his position as president; in fact, in the circumstances here disclosed this stock had a peculiar or special value to petitioner. Payment of the $1,000,000 demand in a lump sum threatened a destruction, to a considerable extent, of his capacity to earn income. Among other controversies was the claim of Mrs. Baer to 5,000 shares of stock in the Stix, Baer and Fuller Company.* It was through the efforts of Mrs. Baer's attorneys that while this stock was turned over to Mrs. Baer, voting power of it was permanently fixed in petitioner and her right of disposing of the stock was left largely in his control, thus further protecting him in the control of the company, and it was through their efforts that the plan was worked out by which he was placed in the position to meet these obligations and yet remain in control of the company and his stock therein. In so doing they were, we think, conserving and maintaining property held by Baer for the production of income.

It was early determined that reconciliation between petitioner and his wife was not possible and he had little concern as to the divorce proceeding; in fact, he interposed no answer. There was apparently but little occasion for the services of counsel in the divorce proceeding proper. That the services of petitioner's counsel were largely so devoted was recognized by the Tax Court in its finding that to one of these attorneys he paid $10,000, of which about 90 per cent was received for services rendered in connection with the form and amount of alimony to be paid to the wife and that to the other attorney he paid $8,787.60, of which about 80 per cent was paid for services in the negotiations as to form and amount of alimony. The amount devoted to the latter named purpose amounts in the aggregate to $16,500. The services of these attorneys were certainly appropriate, and hence, the payments were necessary, and if for the conservation or maintenance of property held for the production of income, then they were deductible from his gross income.

Prior to 1942, Section 23 permitted a deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It made no provision for nonbusiness expenditures. The Supreme Court, in *Higgins* v. *Commissioner*, 312 U.S. 212, held that expenses incurred by a taxpayer in looking after his income-producing property were not deductible because not incurred in carrying on any trade or business. As a result of this decision Congress added the provision 23(a)(2), above quoted. The legislative intent in

* These shares were in Mrs. Baer's name, but the certificates were in her husband's possession, and she had brought a replevin action for them. [Ed.]

enacting this Section 23(a)(2), if that may be said to be obscure, is disclosed in the report of the House Ways and Means Committee, H. Rpt. No. 2333, 77th Congress, 1st Session, 1942-2 C.B. 373, from which we quote as follows.

> The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Dut partly to the inadequacy of the statute and partly to court decisions, non-trade or non-business expenses are not deductible, although non-trade or non-business income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.

Following this change in the law, the Supreme Court, in *Trust of Bingham v. Commissioner*, 325 U.S. 365, held that attorney fees paid by the trustee in contesting an income tax deficiency assessment and in winding up the trust after its expiration were deductible under Section 23(a)(2) of the Internal Revenue Code. In the course of the opinion in that case, referring to the decision of the Court of Appeals in the same case, it is said·

> It (the Court of Appeals) thought that the expenses of contesting the income tax had nothing to do with the production of income and hence were not deductible as expenses "for the production of income" within the meaning of the statute. The court also thought that these expenses were not deductible, because they were paid in connection with property held by the trustees "ready for distribution," and hence not "for the production of income." Similarly it held that the fees for professional services rendered in connection with the payment of legacies and the distribution of the trust fund, were not expenses relating to the management of property held for the production of income, since they were rendered after the trust term had expired and when the property was ready for distribution....
>
> We think that these objections to the deductions fail to take proper account of the plain language of Section 23(a)(2), and the purpose of the section as disclosed by its statutory setting and legislative history; ....
>
> Here the decision of the Court of Appeals was that the expenses were not deductible because they were not for the purpose of producing income or capital gain, and because the trust property, being ready for distribution, was no longer held for the production of income.

After holding that the expenses connected with the devolution of the trust property were deductible, the court said:

> What we have said applies with equal force to the expenses of contesting the tax deficiency. Section 23(a)(2) does not restrict deductions to those litigation expenses which alone produce income. On the contrary, by its terms and in analogy with the rule under Section 23(a)(1), the business expense section, the trust, a taxable entity like a business, may deduct litigation expenses when they are directly connected with or proximately result from the enterprise—the management of property held for the production of income.

Here the services, to the extent found by the Tax Court, were not to prevent the payment of the liability due Mrs. Baer but to so adjust the method of satisfying that liability as not unnecessarily to reduce petitioner's income from the property which confessedly he owned, and hence it was for the purpose of conserving and maintaining this income-producing property. This property was held by him for the production of income. In 1947, the year here involved, he received in excess of $135,000 in dividends and over $100,000 in salary from Stix, Baer and Fuller Company. If the claim for over $1,000,000 of petitioner's property were required to be paid in a lump sum, it would have forced petitioner to relinquish control of the source of his income.

It is, however, urged that the deductions were not allowable because Section 24(a)(1) of the Internal Revenue Code denies deduction for "personal living or family expenses." The mere fact that the same attorneys acted for petitioner in connection with his domestic controversy does not convert the services rendered by them in the matter of the negotiation of the agreement by which the liability to Mrs. Baer for property was so adjusted as to conserve and protect Mr. Baer's specific holdings in Stix, Baer and Fuller Company to personal living or family expenses of Mr. Baer. The Tax Court recognized the two classes of service. This expenditure had a proximate and direct relation to the conservation and maintenance of specific property, the ownership or control of which enabled petitioner to receive income. These fees did not constitute personal family expenses. *Barbara B. LeMond*, 13 T.C. 670; *Elsie B. Gale*, 13 T.C. 661. In the *LeMond* case the facts were somewhat similar to the instant case. In the course of the opinion in that case the Tax Court said·

> . . . the record indicates that the petitioner and her husband had actually separated by mutual agreement prior to negotiation of the separation agreement of July 27, 1943, and that the attorneys to whom the fees in question were paid were solely concerned with the financial aspects of the separation rather than with the settlement of the personal or marital difficulties of the petitioner and her husband. Therefore, it is our opinion that no part of the legal expenses herein constituted personal family expenses and that no allocation of the legal fees in that respect is necessary.

The case of *Lindsey C. Howard*, 16 T.C. 157, is cited as authority for the holding that the expense for the attorney fees there involved was a personal living or family expense. In that case it is to be observed that

> The litigation . . . was in no wise related to petitioner's business activity. The whole situation involved personal (as distinguished from business) relationships and personal considerations. . . . Throughout the entire history and development of income tax law there has existed a sharply defined distinction between business expenses allowable as deductions and non-allowable personal expenses.

The *Howard* case is readily distinguishable from the instant case. The question involved in this case was whether Mrs. Baer might enforce her demand for alimony in a lump sum sufficient in amount to cause a breakup of petitioner's stockholdings. The negotiations looking to the prevention of this threat had to do, we think, with the conservation and maintenance of income-producing property owned by the petitioner.

The government now relies quite strongly on the decision of the Supreme Court in *Lykes* v. *United States*, 343 U.S. 118, handed down since the submission of the instant case. In that case Lykes "gave to his wife and to each of his three children, respectively, 250 shares of common stock in Lykes Brothers, Inc., a closely held family corporation" In his Federal gift tax returns he valued the shares at $120.00 each and on that basis paid a gift tax. The Commissioner, however, revalued the stock and notified Lykes of a gift tax deficiency in a large sum. Lykes employed attorneys to contest this increase in the gift tax and ultimately secured a settlement for somewhat less than the amount claimed. In his current income tax return he made no claim for deduction on account of attorney fees which he had paid counsel but later claimed a tax refund on the ground that the attorney fees should have been deducted under Section 23(a)(2) of the Internal Revenue Code. The claim was denied, whereupon suit was brought in the District

Court and the matter in due course reached the Supreme Court. In the course of the opinion the court, among other things, said:

> Insofar as gifts to members of a donor's family are in the nature of personal or family expenses, the donor's expenditures for accounting, legal or other services incurred in making those gifts are of a like nature. The nondeductibility of such expenditures, therefore, is indicated both by the absence of any affirmative allowance of their deductibility under Section 23 and by the express denial of the deductibility of all personal or family expenses under Section 24. . . .
>
> Inasmuch as the ordinary and necessary character of the legal expenses incurred in the instant case is not questioned, their deductibility turns wholly upon the nature of the activities to which they relate. The first issue, therefore, is whether petitioner's gifts, and the legal expenses related to them, were made for the "production or collection of income" within the meaning of Section 23(a)(2). Generally a gift is the antithesis of such production or collection because it reduces the donor's resources whether income producing or not. However, petitioner suggests that although he stated in his gift tax return that the purpose of his gifts was to express his love for the donees, yet the gifts were part of a general plan to produce income for himself. In support of this, he points out that the gifts consisted of 1,000 shares of stock in a closely held family corporation of which he is the president and in which he retained personal ownership of about 2,000 like shares, and that one of the donees, his son is now actively identified with the corporation and is one of its directors.

In the *Lykes* case the court in affirming the decision of the Court of Appeals held that the transfers were gifts and that the attorney fees were not proximately related to the production of income. The services in that case were relative to property which the taxpayer had given away, and, as pointed out by the court, thereby reduced, rather than conserved, the property held by him for income-producing purposes. The activities of the attorneys in the instant case, on the other hand, were directed to the conservation and maintenance of property held by their client for income producing purposes. The facts in the *Lykes* case are so unlike those in the case at bar as to rob it of any persuasive force. Lykes made gifts to members of his family—clearly a family transaction which had nothing to do with the conservation or maintenance of specific property held by him for income producing purposes.

We conclude that petitioner was entitled to deduct from his gross income the sum of $16,500 paid to his attorneys as an expense incurred to conserve and maintain income-producing property owned by him. The judgment of the Tax Court is therefore modified and the cause remanded to that court for further proceedings consistent herewith.

WOODROUGH, Circuit Judge, *dissenting* in part. . . .

I think the attorneys worked to minimize "personal, living or family expenses" of the taxpayer and did nothing in the "production or collection of income" or in the "management, conservation or maintenance of property."

It seems to me that the decision here has gone counter to the decision handed down by the Supreme Court in *Lykes* v. *United States*, 343 U.S. 118 (1952). There attorneys' fees sought to be deducted under Section 23(a)(2) were paid to attorneys who worked to minimize expense to the taxpayer incidental to certain gifts made by him. Gifts are the antithesis of "production of income" or "conservation of property" and because the services were attributable to the gifts, the cost of the attorneys' services was held not to be deductible.

This case should turn on the same principle. The attorneys' services here were

to minimize the cost to the taxpayer of the settlement of his family difficulties. Therefore the matter to which the fees were attributable was as far removed from "production of income" or "conservation of property" as was the making of gifts in the *Lykes* case. But it is the matter to which the services are attributable that controls and I think the decision in the *Lykes* case clearly admonishes against sanctioning deduction under Section 23(a)(2) in this case.

Note

Although the *Lykes* case held that legal fees incurred in contesting a gift tax deficiency were not deductible, the regulations provided that expenses in the determination of income tax liability were deductible. Regs. 118, Sec. 39.23(a)–15(k). Section 212(3) of the 1954 Code overruled the *Lykes* case; it covers all types of taxes, state and local as well as federal.

COMMISSIONER v. FLOWERS

Supreme Court of the U. S., 1946
326 U.S. 465, reh. den. 326 U.S. 812

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of § 23(a)(1)(A) of the Internal Revenue Code allowing a deduction for income tax purposes of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business."

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There he has paid taxes, voted, schooled his children and established social and religious connections. He built a house in Jackson nearly thirty years ago and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.

In 1906 the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927 he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927 and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of general solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of

time he would spend in each of the two cities and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile but not in Jackson. When he worked in Jackson his law firm provided him with office space, although he no longer participated in the firm's business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary's expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer's participation was advisory only and was no different from his participation in the railroad's legal business in other areas.

The taxpayer's principal post of business was at the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson and the taxpayer participated in that litigation.

During 1939 he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940 he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted $900 in his 1939 income tax return and $1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile.[1] The Commissioner disallowed the deductions, which action was sustained by the Tax Court. But the Fifth Circuit Court of Appeals reversed the Tax Court's judgment, 148 F.2d 163, and we granted certiorari because of a conflict between the decision below and that reached by the Fourth Circuit Court of Appeals in *Barnhill* v. *Commissioner*, 148 F.2d 913.

The portion of § 23(a)(1)(A) authorizing the deduction of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business" is one of the specific examples given by Congress in that section of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It is to be contrasted with the provision of § 24(a)(1) of the Internal Revenue Code, . . . disallowing any deductions for "personal, living, or family expenses." And it is to be read in light of the interpretation given it by Sec. 39.23(a)-2 of Treasury Regulations 118, promulgated under the Internal Revenue Code. This interpretation, which is precisely the same as that given to identical traveling expense deductions authorized by prior and successive Revenue Acts, is deemed to possess

[1] No claim for deduction was made by the taxpayer for the amounts spent in traveling from Mobile to Jackson. He also took trips during the taxable years to Washington, New York, New Orleans, Baton Rouge, Memphis and Jackson (Tenn.), which were apparently in the nature of business trips for which the taxpayer presumably was reimbursed by the railroad. No claim was made in regard to them.

implied legislative approval and to have the effect of law. *Helvering* v. *Winmill*, 305 U.S. 79, 59 S. Ct. 45, 83 L. Ed. 52; *Boehm* v. *Commissioner*, 326 U.S. 287, 66 S. Ct. 120. In pertinent part, this interpretation states that

Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, the railroad fares are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses. . . . Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. . . . Commuters' fares are not considered as business expenses and are not deductible.

Three conditions must thus be satisfied before a traveling expense deduction may be made under § 23(a)(1)(A):

(1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.
(2) The expense must be incurred "while away from home."
(3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

Whether particular expenditures fulfill these three conditions so as to entitle a taxpayer to a deduction is purely a question of fact in most instances. See *Commissioner* v. *Heininger*, 320 U.S. 467, 475, 64 S. Ct. 249, 254, 88 L. Ed. 171. And the Tax Court's inferences and conclusions on such a factual matter, under established principles, should not be disturbed by an appellate court. *Commissioner* v. *Scottish American Co.*, 323 U.S. 119, 65 S. Ct. 169; *Dobson* v. *Commissioner*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248.

In this instance, the Tax Court without detailed elaboration concluded that "The situation presented in this proceeding is, in principle, no different from that in which a taxpayer's place of employment is in one city and for reasons satisfactory to himself he resides in another." It accordingly disallowed the deduction on the ground that they represent living and personal expenses rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court's findings of fact but reversed its judgment on the basis that it had improperly construed the word "home" as used in the second condition precedent to a traveling expense deduction under § 23(a)(1)(A). The Tax Court, it was said, erroneously construed the word to mean the post, station or place of business where the taxpayer was employed—in this instance, Mobile—and thus erred in concluding that the expenditures in issue were not incurred "while away from home." The Court below felt that the word was to be given no such "unusual" or "extraordinary" meaning in this statute, that it simply meant "that place where one in fact resides" or "the principal place of abode of one who has the intention to live there permanently." 148 F.2d at page 164. Since the taxpayer here admittedly had his home, as thus defined, in Jackson and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word "home" in § 23(a)(1)(A) with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. 4 Mertens, *Law of Federal Income Taxation* (1942) § 25.82. The Tax Court and the administrative rulings [2] have consistently defined it as the equivalent of the taxpayer's place of business. See *Barnhill* v. *Commissioner*, *supra*, 4 Cir. On the other hand, the decision below and *Wallace* v. *Commissioner*, 9 Cir., 144 F.2d 407, have flatly rejected that view and have confined the term to the taxpayer's actual residence. See also *Coburn* v. *Commissioner*, 2 Cir., 138 F.2d 763.

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court's opinion, as we read it, was grounded neither solely nor primarily upon that agency's conception of the word "home." Its discussion was directed mainly toward the relation of the expenditures to the railroad's business, a relationship required by the third condition of the deduction. Thus even if the Tax Court's definition of the word "home" was implicit in its decision and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad's business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. There is no claim that the Tax Court misconstrued this condition or used improper standards in applying it. And it is readily apparent from the facts that its inferences were supported by evidence and that its conclusion that the expenditures in issue were non-deductible living and personal expenses was fully justified.

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer's employer, the railroad. Jackson was his regular home. Had his post of duty been in that city the cost of maintaining his home there and of commuting or driving to work concededly would be non-deductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer's post of duty was in Mobile, thereby increasing the costs of transportation, food and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad's business as were his personal and living costs in Jackson. They were incurred solely as the result of the taxpayer's desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad's legal business. The railroad did not require him to travel on business from Jackson to Mobile or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile

[2] Section 39.23(a)-2 of Treasury Regulations 118 does not attempt to define the word "home" although the Commissioner argues that the statement therein contained to the effect that commuters' fares are not business expenses and are not deductible "necessarily rests on the premise that 'home' for tax purposes is at the locality of the taxpayer's business headquarters." Other administrative rulings have been more explicit in treating the statutory home as the abode at the taxpayer's regular post of duty. See e.g. O.D. 1021, 5 Cum. Bull. 174 (1921); I.T. 1264, I-1 Cum. Bull. 122(1922), I.T. 3314, 1939-2 Cum. Bull. 152; G.C.M. 23672, 1943 Cum. Bull. 66.

as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer's work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of § 23(a)(1)(A) could arise only when the railroad's business forced the taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors. Such was not the case here.

It follows that the court below erred in reversing the judgment of the Tax Court.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

Mr. Justice RUTLEDGE, *dissenting.*

I think the judgment of the Court of Appeals should be affirmed. When Congress used the word "home" in § 23 of the Code, I do not believe it meant "business headquarters." And in my opinion this case presents no other question.

Congress allowed the deduction for "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business." . . .

Respondent's home was in Jackson, Mississippi, in every sense, unless for applying § 23. There he maintained his family, with his personal, political and religious connections, schooled his children, paid taxes, voted, and resided over many years. There too he kept hold upon his place as a lawyer, though not substantially active in practice otherwise than to perform his work as general counsel for the railroad. This required his presence in Mobile, Alabama, for roughly a third of his time. The remainder he spent in Jackson at the same work, except for the time he was required to travel to points other than Mobile.

The company's principal offices were there, including one set aside for respondent's use. But the bulk of its trackage was in Mississippi and much of its legal work, with which he was concerned, was done there. His choice to keep his home in Jackson must have been affected by this fact, although it was motivated chiefly by more purely personal considerations. It is doubtful indeed, though perhaps not material, whether by not moving to Mobile he did not save the Government from larger deductions on account of traveling expense than those he claimed. . . .

Because the taxpayer elected to keep his home in Jackson, rather than move to Mobile, and because his employer did not undertake to pay these expenses, [the Tax Court] viewed the case as being the same as if he had moved to Mobile. In that event it said, he would have been required to bear the expenses of his own meals and lodging. This is obvious, even though the "as if" conclusion does not follow.

The court went on, however, to give the further reason for it: "The situation . . . is, in principle, no different from that in which a taxpayer's place of employment is in one city and for reasons satisfactory to himself he resides in another." It seems questionable whether, in so ruling, the Tax Court has not confused the taxpayer's principal place of employment with his employer's. For on the facts Jackson rather than Mobile would seem more appropriately to be found *his* business headquarters. But, regardless of that, the authorities cited and the Government's supporting argument show that the case was regarded as in essence the commuter's, excepted by the regulations.

Apart from this ruling, the Tax Court made no finding, of fact or law, that respondent was not engaged "in the pursuit of a trade or business"; that he was not "away from home"; that the expenses were not "business expenses" or "business traveling expenses"; or that they were not "ordinary and necessary." Yet by a merry-go-round argument which always comes back to rest on the idea that "home" means "business headquarters," the Government seeks to inject such issues and findings, including a *Dobson* v. *Com'r*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248, contention, into the Tax Court's determination. I think there was only one issue, a question of law requiring construction of the statute as to the meaning of the word "home" and, if that is resolved against the Government, the Tax Court's judgment has no other foundation on which to stand. Every other contention falls when this one does. All stand if it is valid.

I agree with the Court of Appeals that if Congress had meant "business headquarters," and not "home," it would have said "business headquarters." When it used "home" instead, I think it meant home in everyday parlance, not in some twisted special meaning of "tax home" or "tax headquarters." I find no purpose stated or implied in the Act, the regulations or the legislative history to support such a distortion or to use § 23 as a lever to force people to move their homes to the locality where their employer's business headquarters may be, although their own work may be done as well in major part at home. The only stated purpose, and it is clearly stated, not in words of art, is to relieve the tax burden when one is away from home on business.

The Government relies on administrative construction, by the Commissioner and the Tax Court, and says that unless this is accepted the Act creates tax inequality. If so, it is inequality created by Congress, and it is not for the Commissioner or the Tax Court, by administrative reconstruction, to rewrite what Congress has written or to correct its views of equality. Moreover, in my opinion, the inequity, if any, comes not from the statute or the regulation but from the construction which identifies petitoner with a commuter.

That word too has limitations unless it also is made a tool for rewriting the Act. The ordinary, usual connotation, *cf.* 21 I.C.C. 428; *Pennsylvania R. Co.* v. *Towers,* 245 U.S. 6, 12, 38 S. Ct. 2, 4, 62, L. Ed. 117, L.R.A. 1918C, 475, does not include irregular, although frequent journeys of 350 miles, requiring Pullman accommodations and some twelve to fifteen hours, one way.

Congress gave the deduction for traveling away from home on business. The commuter's case, rightly confined, does not fall in this class. One who lives in an adjacent suburb or city and by usual modes of commutation can work within a distance permitting the daily journey and return, with time for the day's work and

a period at home, clearly can be excluded from the deduction on the basis of the section's terms equally with its obvious purpose. But that is not true if "commuter" is to swallow up the deduction by the same sort of construction which makes "home" mean "business headquarters" of one's employer. If the line may be extended somewhat to cover doubtful cases, it need not be lengthened to infinity or to cover cases as far removed from the prevailing connotation of commuter as this one. Including it pushes "commuting" too far, even for these times of rapid transit. . . .

By construing "home" as "business headquarters"; by reading "temporarily" as "very temporarily" into § 23; by bringing down "ordinary and necessary" from its first sentence into its second; by finding "inequity" where Congress has said none exists; by construing "commuter" to cover long-distance, irregular travel; and by conjuring from the "statutory setting" a meaning at odds with the plain wording of the clause, the Government makes over understandable ordinary English into highly technical tax jargon. There is enough of this in the tax laws inescapably, without adding more in the absence of either compulsion or authority. The arm of the tax-gatherer reaches far. In my judgment it should not go the length of this case. Congress has revised § 23 once to overcome niggardly construction.[1] It should not have to do so again.

Note

1. How permanent a post must the taxpayer have before his expenses while there will be disallowed? If a business man goes to another city to see a customer, he can deduct his expenses for travel, meals, and lodging. But what is the status of a professor who teaches for a summer or a year at another university; or a man who in war-time takes a job in another city for the duration? The courts have distinguished between "temporary" employment, when the expenses will be deductible, and "indefinite" employment, where they will be disallowed. See *Coburn* v. *Commissioner*, 138 F.2d 763 (2d Cir. 1943); *Leach* v. *Commissioner*, 12 T.C. 20 (1949); *Carragan* v. *Commissioner*, 197 F.2d 246 (2d Cir. 1952); *Carroll* v. *Commissioner*, 20 T.C. 382 (1953).

Is the deduction disallowed if the taxpayer during temporary employment away from "home" takes his family along and vacates or sub-lets his house, though intending to return either to the same house or the same city at the end of the period of employment? Is a taxpayer "away from home" if he holds a job of indefinite duration in a locality to which he cannot move his family? It was held not in *Formel* v. *Commissioner*, ¶ 50,221 P-H Memo TC, involving an American engineer who worked for 2½ years in Soviet Russia, see also *Bercaw* v. *Commissioner*, 165 F.2d 521 (4th Cir. 1948), involving an Army officer. In *Mitnick* v. *Commissioner*, 13 T.C. 1 (1949), a bachelor who travelled constantly as the road manager of a theatrical company was held to have no "home" to be away from, within the meaning of § 162(a). See also *Martin* v. *Commissioner*, 44 B.T.A. 185 (1941) (seaman with no home ashore). Would a married man with similar employment be entitled to the deduction if his wife and children did not travel with him? What about a bachelor in such employment for whom a fond mother kept a room ready at all times? See *Gustafson* v. *Commissioner*, 3 T.C. 998 (1944). If a taxpayer travels on business to another city for one day, is he "away from home" so as to permit deduction of the cost of lunch? See *Amoroso* v. *Commissioner*, 193 F.2d 583 (1st Cir.), cert. den. 343 U.S. 926 (1952); *Scott* v. *Kelm*, 110 F. Supp. 819 (D. Minn. 1953).

[1] The Treasury Regulations in force in 1920 allowed deduction of only the excess of the cost of meals and lodging away from home over the cost at home; and under earlier regulations none of this expense was allowed. Congress inserted the words "all" and "entire" in the 1921 Act to overcome this ruling.

2. What if the taxpayer in the *Flowers* case had continued to practice law in Jackson after he took the Mobile railroad job? The Tax Court would apparently permit his expenses in Mobile to be deducted if the business activity in Jackson was substantial, even though the income therefrom was less than the Mobile income. *Sherman* v. *Commissioner*, 16 T.C. 332 (1951) (four judges dissenting). Suppose the taxpayer lived half-way between the two business posts? A somewhat related problem is whether, if both husband and wife work in different localities, either of them can deduct the expenses of being away from the "home." In *Wallace* v. *Commissioner*, 144 F.2d 407 (9th Cir. 1944), an actress domiciled in San Francisco (where her husband worked) was allowed to deduct the expenses of a six months' stay in Hollywood. The court's reasoning is somewhat weakened by the subsequently decided *Flowers* case, but in *Stairwalt* v. *Commissioner*, ¶ 52,261 P-H Memo TC, the Tax Court hinted (though deciding the case before it on another ground) that the wife should be allowed to deduct such expenses because of "the possible considerations of public policy inherent in creating as few inducements as possible to the maintenance of separate domiciles for husband and wife." In *Hammond* v. *Commissioner*, 213 F.2d 43 (5th Cir. 1954), where the husband worked in Baton Rouge but the wife worked and maintained the home in New Orleans, the husband's expenses were disallowed. In *Albert* v. *Commissioner*, 15 T.C. 350 (1950), a married woman who worked away from the family home (traveling by car daily during good weather and remaining away weekdays during bad) was denied traveling expenses on the theory that her employment (in a war plant) was of indefinite duration. Should this fact be important where both husband and wife (rather than only one) are working?

3. Even before the *Flowers* case was decided, it was held that the "home" of a Congressman is Washington, D. C., so that living expenses while there are non-deductible, and that the cost of the trips back "home" to keep in touch with constituents are non-deductible campaign expenses. *Lindsay* v. *Commissioner*, 34 B.T.A. 840 (1936). Congress has since provided, however, that the home of a member is in his district, but that living expenses in Washington may not be deducted in excess of $3,000 per year Section 162(a). As to members of state legislatures, see I T. 3842, 47-1 C.B. 11.

4. Since all "ordinary and necessary expenses . . . in carrying on any trade or business" are deductible under § 162(a)(1), what is added by the specific allowance of "traveling expenses?" In at least one respect, the former phrase is *broader* than the latter: a taxpayer who is not "away from home" (*e.g.*, a salesman who travels only in his home town, a traveling salesman who has no home) can deduct his automobile expenses and railroad fares as "business expenses" though they do not qualify as "traveling expenses." Note that § 212, relating to the expenses of an individual in profit-seeking activities that do not constitute a trade or business, contains no specific reference to traveling expenses. If an investor goes to another city to inspect his income-producing property, can he deduct his expenses in the same way as a business man who makes a trip to inspect his business property?

5. See generally Comment, Living Expenses While "Away From Home"; Business or Personal, 19 *U. of Chi. L. Rev.* 534 (1952), McDonald, "Travel and Entertainment Expenses," *11th Annual N.Y.U. Inst. on Fed. Taxation* 1173 (1953). On the deductibility of moving expenses, see Bittker, "The Individual as Wage Earner," *id.*, 1147, 1166–71.

(b) Expense or investment?

MIDLAND EMPIRE PACKING CO. v. COMMISSIONER

Tax Court of the U. S., 1950

14 T.C. 635

ARUNDELL, Judge: The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created

by a neighboring refinery is deductible as an ordinary and necessary expense under section 23(a) of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section 23 (f) of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes. Treasury Regulations 111 [q.v.] is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In *Illinois Merchants Trust Co., Executor,* 4 B.T.A. 103, at page 106, we discussed this subject in some detail and in our opinion said.

It will be noted that the first sentence of the article [now Regulations 118, Sec. 39.23(a)-4] relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

It will be seen from our findings of fact that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oil-proof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oil-proof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that

the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

While it is conceded on brief that the expenditure was "necessary," respondent contends that the encroachment of the oil nuisance on petitioner's property was not an "ordinary" expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of "ordinary" for, as stated in *Welch* v. *Helvering*, 290 U.S. 111,

> ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. . . . the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser* v. *United States*, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part.

Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

In *American Bemberg Corporation*, 10 T.C. 361, we allowed as deductions, on the ground that they were ordinary and necessary expenses, extensive expenditures made to prevent disaster, although the repairs were of a type which had never been needed before and were unlikely to recur. In that case the taxpayer, to stop cave-ins of soil which were threatening destruction of its manufacturing plant, hired an engineering firm which drilled to the bedrock and injected grout to fill the cavities where practicable, and made incidental replacements and repairs, including tightening of the fluid carriers. In two successive years the taxpayer expended $734,316.76 and $199,154.33, respectively for such drilling and grouting and $153,474.20 and $79,687.29, respectively, for capital replacements. We found that the cost (other than replacement) of this program did not make good the depreciation previously allowed, and stated in our opinion:

> In connection with the purpose of the work, the Proctor program was intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before. The purpose was not to rebuild or replace the plant in whole or in part, but to keep the same plant as it was and where it was.

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a

century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations.

In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner's alternative contention that the expenditure is deductible as a business loss, nor need we heed the respondent's argument that any loss suffered was compensated for by "insurance or otherwise."

Note

1. With the foregoing, compare the following:

> We do not agree that the installation of the sprinkler system [in a hotel] constituted a repair made "for the purpose of keeping the property in an ordinarily efficient operating condition." *Cf. Illinois Merchants Trust Co.*, 4 B.T.A. 103, 106, cited by petitioner. It was a permanent addition to the property ordered by the city of New York to give the property additional protection from the hazard of fire. It was an improvement or betterment having a life extending beyond the year in which it was made and which depreciates over a period of years. While it may not have increased the value of the hotel property or prolonged its useful life, the property became more valuable for use in the petitioner's business by reason of compliance with the city's order. The respondent did not err in determining that the cost of this improvement or betterment should be added to petitioner's capital investment in the building, and recovered through depreciation deductions in the years of its useful life. *Hotel Sulgrave, Inc.* v. *Com'n*, 21 T.C. 619, 621 (1954).

2. See Shugerman, "Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations," 49 *Mich. L. Rev.* 213 (1950). Except for §§ 263(a)(1) and 263(a)(2), the Internal Revenue Code makes no attempt to define a capital expenditure. The American Law Institute in its model Income Tax Statute draws the line of distinction at three years' life and $500 value. Should frequency of purchase necessarily be conclusive on the character of the expenditure? When would a taxpayer prefer to capitalize an expenditure, assuming he had an unrestricted choice? Where the lessee of property makes improvements to the leased property, they are a capital investment. Regs. 118, Sec. 39.23(a)-10(b). The lessee may deduct the cost over the remaining years of the lease or over the estimated life of the improvements, whichever is shorter. What if the lease is of the year-to-year nature?

3. Sec. 162(a)(3) permits the deduction of rental payments for the use of trade or business property to which the taxpayer "has not taken or is not taking title or in which he has no equity." Suppose the lessee is to pay a stipulated annual rental for a period of time, at the end of which he is to receive the property in fee simple. Are the rental payments then deductible? *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952). What if the lessee has an option to purchase the property during or at the end of the period?

HOCHSCHILD v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1947
161 F.2d 817

Before SWAN, CHASE and FRANK, Circuit Judges.

CHASE, Circuit Judge.

In his income tax return for the calendar year 1939 the petitioner deducted $4,125 which he had paid in that year as attorney's fees incurred in the successful

defense of a stockholder's derivative suit brought against him and others in the state court in New York. The Commissioner disallowed the deduction in full. The Tax Court disallowed the deduction in part and this petition was brought to review that decision.

The pertinent facts were not disputed and were found in accordance with a stipulation filed by the parties. They are that the petitioner has been a director and substantial stockholder of The American Metal Company, Ltd., a New York corporation, from November 22, 1916 to at least the date of the beginning of the proceedings in the Tax Court and, since May 24, 1917 has also been one of its principal officers. In accordance with a long standing practice of The American Metal Company its directors, officers, stockholders and employees were permitted to participate in new ventures which it undertook. A syndicate, formed in November 1916 consisting of The American Metal Company and a number of its directors, officers, employees and stockholders, acquired an option upon certain molybdenum properties at Climax, Col. The option was exercised and a Delaware corporation called Climax Molybdenum Company was organized in January 1917 to which the syndicate's property was transferred in consideration for its capital stock and the petitioner then became a stockholder of Climax in proportion to his interest in the syndicate. He has remained a stockholder and has been a director and part of the time an officer of Climax at least up to the commencement of the proceedings below.

The Climax venture at length proved to be a financial success and in December 1938 a stockholder's derivative suit was brought in the New York Supreme Court, New York County, against the petitioner and others for the benefit of The American Metal Company in which the petitioner and others were charged with breaches of their fiduciary duties to the Metal Company in respect to the Climax venture. It was consolidated for trial with a similar suit thereafter commenced in the same court. The petitioner was partly successful in defending that suit in the trial court, Sup., 36 N.Y.S.2d 856, and upon appeal a judgment of the Appellate Division of the Supreme Court, 268 App. Div. 239, 50 N.Y.S.2d 800, which became final, completely vindicated him.

The plaintiffs in the above mentioned suit sought, *inter alia*, (1) to impress a trust upon the Climax stock held by the petitioner, (2) an accounting for damages and profits, and (3) an accounting for the value of any shares of Climax which the petitioner had held but was unable to transfer to The American Metal Company by reason of his sale or other disposition of them.

The petitioner had acquired 1,500 shares of Climax stock in 1918, 1,500 additional shares in 1920-21 and had surrendered 321 of them in 1926 in the settlement of litigation between Climax and the Metal Company. The Climax stock was split 10 for one in 1929 and three for one in 1935. During the period 1933 to 1939 inclusive the petitioner received dividends on his Climax stock amounting in the aggregate to $1,281,331.95.

The attorney's fees which the petitioner paid in making his successful defense of the suit in the state court were claimed to be deductible under Sec. 23(a)(1)(A) of the Internal Revenue Code, as ordinary and necessary expenses paid during the taxable year in carrying on a trade or business and, in the alternative, under Sec. 23(a)(2) of the Code as necessary expenses paid during the taxable year for the

production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

The Tax Court allocated $3,581.84 of the fees paid to the expense of defending the equitable title to the petitioner's Climax stock and held that part of it was not deductible because it was the cost of defending the title to property and thus a capital expenditure within Regs. 118, Sec. 39.24(a)-2. The remainder was allowed as a deduction on the ground that it was paid to retain income after it was collected and was to be treated for purposes of deduction as though paid for the collection of the income. In this the Commissioner acquiesced.

As there is no dispute as to any of the facts or as to the allocation already made by the Tax Court, the sole issue is one of law reviewable in this court. *Helvering* v. *Stormfeltz*, 8 Cir., 142 F.2d 982. See *Bingham* v. *Commissioner*, 325 U.S. 365, 65 S. Ct. 1232, 89 L. Ed. 1670.

The petitioner when acting as a director and officer of The American Metal Company was engaged in carrying on a trade or business within the meaning of the above statute. *Commissioner* v. *People's-Pittsburgh Trust Co.*, 3 Cir., 60 F.2d 187; *Foss* v. *Commissioner*, 2 Cir., 75 F.2d 326. The fees paid were ordinary and necessary expenses which were directly connected with such business, being paid to defend a lawsuit in which he was charged with breaches of the fiduciary duties he owed the corporation he served as a director and officer. *Commissioner* v. *Heininger*, 320 U S. 467, 64 S. Ct. 249, 88 L. Ed. 171, *Welch* v. *Helvering*, 290 U.S. 111, 54, S. Ct. 8, 78 L. Ed. 212, *Kornhauser* v. *United States*, 276 U.S. 145, 48 S. Ct. 219, 72 L. Ed. 505. He owed the corporation no duty as a fiduciary merely because he was a stockholder; his liability so alleged being solely that of a malfeasant director and officer and on that decision turned. The significance of his status as a stockholder is limited to the fact that, had the breaches of fiduciary duties been established, the state court would have had the opportunity as well as the power to deprive him of the Climax stock he still held and not have had to confine its relief to money damages.

Regardless of what effect an adverse decision might have had upon the title to his Climax stock, it was necessary for him to defend the lawsuit to protect himself from being compelled to account generally for the alleged breaches of the duties to The American Metal Company. And all the ordinary and necessary expenses which he paid in the taxable year for such defense were deductible under Sec. 23(a)(1)(A) of the Code as it has been construed in the authorities above cited.

We cannot agree that these fees which the petitioner paid in defense of the lawsuit were any the less deductible because his liability, if proved, might have destroyed his equitable title to the stock he held. His right to keep it was certainly in issue and in that sense his title to it was defended, to be sure, but the title as such was not perfected in any way by his expenditures for legal assistance. He thereby but fended off an abortive attack upon the conduct of his business as a fiduciary and by freeing himself from liability to his corporation to account for such conduct put all of his property beyond the reach of his then accusers. A similar result in this respect was attained by the expenditures allowed as a deduction in the *Kornhauser* case, *supra*. See *Rassenfoss* v. *Commissioner*, 7 Cir., 158 F.2d 764, which sufficiently distinguishes the authorities on which the respondent relies. In further support of our conclusion that these fees are not in any real

sense capital expenditures see *Commissioner* v. *Field*, 2 Cir., 42 F.2d 820 and *Levitt & Sons* v. *Nunan*, 2 Cir., 142 F.2d 795.

Decision reversed.

FRANK, Circuit Judge, *dissents* in part with opinion.

FRANK, Circuit Judge (*dissenting* in part).

To explain my reasons for partially dissenting, I must supplement my colleagues' statement of facts. The complaint in the State court suit, *Turner* v. *American Metal Company*, 268 App. Div. 239, 50 N.Y.S.2d 800 (expressly made part of the stipulation on which the instant case was tried in the Tax Court), charged that, as a result of a conspiracy in which taxpayer and other officers and directors of American Metal had joined, the following had occurred: (a) Taxpayer had himself wrongfully acquired title to certain shares of the Climax Company, and the equitable title to those shares was therefore in American Metal. (b) Taxpayer had aided others in wrongfully acquiring title to certain other Climax shares; some of those others were direct parties to the conspiracy, while still others acquired such shares with full knowledge of the conspiracy; the equitable title to all these shares was asserted to be in American Metal. (c) Taxpayer had aided in causing American Metal wrongfully to spend money for the benefit of Climax, to the damage of American Metal. On this basis, the Turner complaint prayed as follows: (a) That taxpayer be ordered to transfer to American Metal the legal title to the Climax shares which he had wrongfully obtained; (b) that he account for any dividends on those Climax shares,[1] (c) that he and the other conspirators be held liable, jointly and severally, for all damages to American Metal resulting from the conspiracy. I think that these facts call for a nicer analysis than that contained in my colleague's opinion, for the following reasons:

1. In part, the Turner suit sought to hold taxpayer liable merely for damages said to have resulted from his conduct as an official of American Metal. Here I refer to (a) the alleged damages resulting from the moneys said to have been wrongfully paid by American Metal for the benefit of Climax, and (b) the alleged damages to American Metal resulting from the fact that the taxpayer and his alleged co-conspirators aided others than himself in allegedly wrongful acquisition of Climax stock.[2] To that extent, I agree that, in the Turner suit, he was not defending the title to the Climax stock he held or to any other of his property. To rule otherwise would be to say that defense of any suit is a defense against an attack on title to property, since an adverse judgment (through levy of execution or otherwise) may diminish a defendant's property, including, for instance, stock in which he may have invested. Consequently, taxpayer's expense in defending that phase of the Turner suit was, I think, incurred as a result of "carrying on a trade or business." Up to that point, in line with the authorities cited by them, I agree with my colleagues.

2. I think, however, that the same is not true of his defense of that part of the Turner suit which charged him with having himself wrongfully obtained Climax shares and which sought an order directing him to transfer those shares to Ameri-

[1] As to expenses incurred in defending as to this item, the Tax Court decided in favor of taxpayer, and the Commissioner has not appealed.

[2] There would be no such damages if those others still have the shares and were thus able to transfer them to American Metal.

can Metal as its equitable owner. To that extent, the Turner action was a direct attack on his title to the Climax shares.

True, that attack was grounded on the alleged impropriety of his conduct as an American Metal official, coupled with alleged similar improper conduct by other such officials conspiring with him; for the theory of the Turner suit was that only by such conduct had it been possible for him to acquire the Climax shares. But, in that respect, the action was the same as if, not being himself an American Metal officer, taxpayer had obtained Climax stock through action of American Metal officers known to him to be violative of their corporate obligations; in those circumstances, his expense of defending a suit seeking to compel him to transfer the title to such stock to American Metal, as its equitable owner, would not have been incurred in "carrying on a trade or business." So it seems to me that this follows That, in order to succeed in having taxpayer ordered to transfer his Climax stock to American Metal, Turner had to prove that taxpayer's acquisition of that stock, for his own benefit, had been made possible by taxpayer's misconduct as an American Metal official, does not alter the fact that the Turner suit, as to those shares, was a direct attack on taxpayer's title to that stock. In other words, I think it immaterial that the alleged defect in that title stemmed from taxpayer's own alleged deviation from his corporate duties. Wherefore, in defending this phase of the action, taxpayer, I think, was engaged directly in protecting his title to property. See, *e.g.*, *Bowers* v. *Lumpkin,* 4 Cir., 140 F.2d 927, 151 A.L.R. 1336; *Jones Estate* v. *Commissioner,* 5 Cir., 127 F.2d 231; *Levitt & Sons* v. *Nunan,* 2 Cir., 142 F.2d 795; *Levitt & Sons* v. *Commissioner,* 2 Cir., 160 F.2d 209; *Murphy Oil Co.* v. *Burnet,* 9 Cir., 55 F.2d 17; *Moynier* v. *Welch,* 9 Cir., 97 F.2d 471. As here the "matter of title was directly involved and not merely incidental," *Rassenfoss* v. *Commissioner,* 7 Cir., 158 F.2d 764, 768 is distinguishable. For like reasons, I think that none of the other cases cited by my colleagues in support of their conclusion is apposite on this point.

However, taxpayer was, even as to that phase of the Turner suit, also in part defending the way he had functioned as a corporate officer. That part of the expense was, I believe, deductible.

3. Taxpayer made no proof of the appropriate allocation of the expenses as between the items discussed above. Since he had the burden, perhaps, if the foregoing is correct, he should fail. But I think that, in accordance with the doctrine of *Cohan* v. *Commissioner,* 2 Cir., 39 F.2d 540, 543-545, we should remand for determination of the allocation by the Tax Court.

Note

1. Bowers v. *Lumpkin,* 140 F.2d 927, 929 (4th Cir 1944), involved the deductibility under § 212 of legal expenses incurred by the taxpayer in the successful defense of a suit to invalidate a purchase by her of stock from trustees for a charity. The taxpayer argued that even though such expenses might not be deductible under § 162(a) by a person in trade or business, they were deductible under § 212·

> It is contended that the phrase "all the ordinary and necessary expenses" in the amendment [Section 212] covers more ground than it did in the original act [Section 162(a)] because the amendment expressly authorizes a deduction for expenses paid "for the management, conservation, or maintenance of property held for the production of income"; and the word "conservation" is said to be particu-

larly pertinent in the pending case where the expenses were incurred in the protection of income producing stock from adverse attack.

But the court, holding that the phrase "ordinary and necessary expenses" in § 212 must be interpreted in the light of its settled meaning under § 162(a), denied the deduction. See further *Garrett* v. *Crenshaw*, 196 F.2d 185 (4th Cir. 1952), and *Allen* v. *Selig*, 200 F.2d 487 (5th Cir. 1952). May the taxpayer add such expenditures to the basis of the stock in computing gain or loss when it is sold?

2. Would the stockholder who brought the unsuccessful suit involved in the principal case be allowed to deduct or to capitalize his expenditures?

WELCH v. HELVERING

Supreme Court of the U. S., 1933
290 U.S. 111

Mr. Justice Cardozo delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922 petitioner was the secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to re-establish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfillment of that resolve, he made payments of substantial amounts during five successive years. In 1924, the commissions were $18,028.20, the payments $3,975.97; in 1925, the commissions $31,377.07, the payments $11,968.20; in 1926, the commissions $20,925.25, the payments $12,815.72; in 1927, the commissions $22,119.61, the payments $7,379.72, and in 1928, the commissions $26,177.56, the payments $11,068.25. The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital expenditures, an outlay for the development of reputation and good will. The Board of Tax Appeals sustained the action of the Commissioner (25 B.T.A. 117), and the Court of Appeals for the Eighth Circuit affirmed. 63 F.(2d) 976. The case is here on certiorari....

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch* v. *Maryland*, 4 Wheat. 316, 4 L. Ed. 579. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of

a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser* v. *United States*, 276 U.S. 145, 48 S. Ct. 219, 72 L. Ed. 505. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning (*Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484, *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 327, 52 S. Ct. 568, 76 L. Ed. 1128), we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. . . . Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payment figures in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good will of an old partnership. *Cf. Colony Coal & Coke Corp.* v *Commissioner* (C.C.A.) 52 F.(2d) 923. For many, they are the only tools with which to hew a pathway to success, The money spent in acquiring

them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the apprecation of particular situations, at times with border-line conclusions. Typical illustrations are cited in the margin.[1]

The decree should be

Affirmed.

Note

Somewhat similar expenses have been allowed in several cases subsequent to *Welch* v. *Helvering* on a finding that they were made to "protect" and "promote" the taxpayer's existing business, rather than to "acquire" business or good will. Thus, in *Dunn & McCarthy, Inc.* v. *Commissioner*, 139 F.2d 242, 244 (2d Cir. 1943), a corporation was permitted to deduct amounts it paid to certain employees who had lent funds to its former president; he had lost the money gambling at the racetrack and had died insolvent. The Court did not think the payments were "extraordinary": "It was the kind of outlay which we believe many corporations would make, and have made, under similar circumstances." The *Welch* case was distinguished: "Welch made a capital outlay to acquire good will for a new business. In the present case the payment was an outlay to retain an existing good will, that is, to prevent loss of earnings that might result from destroying such good will by failing to recognize the company's moral obligation." In *Carl Reimers Co., Inc.* v. *Commissioner*, 19 T.C. 1235 (1953), a majority of the Tax Court betrayed some skepticism as to the validity of the distinction; in affirming, the Court of Appeals for the Second Circuit adhered to the distinction, not surprisingly in view of the fact that its own decision in the *Dunn & McCarthy* case, *supra*, had created it. 211 F.2d 66 (2d Cir. 1954).

COUGHLIN v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1953

203 F.2d 307

Before AUGUSTUS N. HAND, CHASE and CLARK, Circuit Judges.

CHASE, Circuit Judge.

The petitioner has been a member of the bar for many years and in 1944 was admitted to practice before the Treasury Department. In 1946 he was in active

[1] Ordinary expenses: Commissioner v. People's Pittsburgh Trust Co. (C.C.A.) 60 F.(2d) 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; American Rolling Mill Co. v. Commissioner (C.C A.) 41 F.(2d) 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen (cf. the decisions collated in 30 Columbia Law Review, 1211, 1212, and the distinctions there drawn); Corning Glass Works v. Lucas, 59 App. D.C. 168, 37 F.(2d) 798, 68 A.L.R. 736, donations to a hospital by a corporation whose employees with their dependents made up two-thirds of the population of the city, Harris & Co. v. Lucas (C.C.A.) 48 F.(2d) 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. *Cf.* Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 50 S. Ct. 273, 74 L. Ed. 733, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered. Not ordinary expenses: Hubinger v. Commissioner (C.C.A.) 36 F.(2d) 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; Lloyd v. Commissioner (C.C.A.) 55 F.(2d) 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; One Hundred Five West Fifty-Fifth

practice in Binghamton, N. Y., as a member of a firm of lawyers there. The firm engaged in general practice but did considerable work which required at least one member to be skilled in matters pertaining to Federal taxation and to maintain such skill by keeping informed as to changes in the tax laws and the significance of pertinent court decisions when made. His partners relied on him to keep advised on that subject and he accepted that responsibility. One of the various ways in which he discharged it was by attending, in the above mentioned year, the Fifth Annual Institute on Federal Taxation which was conducted in New York City under the sponsorship of the Division of General Education of New York University. In so doing he incurred expenses for tuition, travel, board and lodging of $305, which he claimed as an allowable deduction under section 23(a) (1) (A) I.R.C., as ordinary and necessary expenses incurred in carrying on a trade or business and no question is raised as to their reasonableness in amount. The Commission disallowed the deduction and the Tax Court, four judges dissenting, upheld the disallowance on the ground that the expenses were non-business ones "because of the educational and personal nature of the object pursued by the petitioner."

The Tax Court found that the Institute on Federal Taxation was not conducted for the benefit of those unversed in the subject Federal taxation and students were warned away. In 1946, it was attended by 408 attorneys, accountants, trust officers, executives of corporations and the like. In 1947, over 1500 of such people from many states were in attendance. It was "designed by its sponsors to provide a place and atmosphere where practitioners could gather trends, thinking and developments in the field of Federal taxation from experts accomplished in that field."

Thus there is posed for solution a problem which involves no dispute as to the basic facts but is, indeed, baffling because, as is so often true of legal problems, the correct result depends upon how to give the facts the right order of importance.

We may start by noticing that the petitioner does not rely upon section 23(a) (2) which permits the deduction of certain non-trade or non-business expenses, but rests entirely upon his contention that the deduction he took was allowable as an ordinary and necessary expense incurred in the practice of his profession. The expenses were deductible under section 23(a) (1) (A) if they were "directly connected with" or "proximately resulted from" the practice of his profession. *Kornhauser* v. *United States,* 276 U.S. 145, 153, 48 S. Ct. 219, 220, 72 L. Ed. 505. And if it were usual for lawyers in practice similar to his to incur such expenses they were "ordinary." *Deputy* v. *DuPont,* 308 U. S. 488, 495, 60 S. Ct. 363, 84 L. Ed. 416. They were also "necessary" if appropriate and helpful. *Welch* v. *Helvering,* 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212. But this is an instance emphasizing how dim a line is drawn between expenses which are deductible because incurred in trade or business, i. e., because professional, and those which are non-deductible because personal. Section 24(a) (1).

Street v. Commissioner (C.C.A.) 42 F.(2d) 849, and Blackwell Oil & Gas Co. v. Commissioner (C.C.A.) 60 F.(2d) 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; White v. Commissioner (C.C.A.) 61 F.(2d) 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.

The respondent relies upon Regs. 118, Sec. 39.23(a)-15(f), which provides that "expenses of taking special courses or training" are not allowable as deductions under section 23(a) (2). But section 23(a) (2) concerns non-trade or non-business expenses. It is not necessary to decide whether, in the light of the regulation, an expense of the nature here involved would be deductible if incurred in connection with a profit-making venture that is not a trade or business. It will suffice to say that, since the expense was incurred in a trade or business within the meaning of section 23(a) (1) (A), the regulation interpreting section 23(a) (2) is not a bar to allowance here.

In *Welch* v. *Helvering*, *supra* 290 U.S. at page 115, 54 S. Ct. at page 9, there is a dictum that the cost of acquiring learning is a personal expense. But the issue decided in that case is far removed from the one involved here. There the taxpayer paid debts for which he was not legally liable whose payment enhanced his reputation for personal integrity and consequently the value of the good will of his business, and it was held that these payments were personal expenses. The general reference to the cost of education as a personal expense was made by way of illustrating the point then under decision, and it related to that knowledge which is obtained for its own sake as an addition to one's cultural background or for possible use in some work which might be started in the future. There was no indication that an exception is not to be made where the information acquired was needed for use in a lawyer's established practice.

Regs. 118, Sec. 39.23(a)-5, makes clear that among the expenses which a professional man may deduct under Section 23(a) (1) (A) are dues to professional societies, subscriptions to professional journals, and amounts currently expended for books whose useful life is short. Such expenses as are here in question are not expressly included or excluded, but they are analogous to those above stated which are expressly characterized as allowable deductions.

This situation is closely akin to that in *Hill* v. *Commissioner*, 4 Cir., 181 F.2d 906, where the expenses incurred by a teacher in attending a summer school were held deductible. The only difference is in the degree of necessity which prompted the incurrence of the expenses. The teacher couldn't retain her position unless she complied with the requirements for the renewal of her teaching certificate; and an optional way to do that, and the one she chose, was to take courses in education at a recognized institution of learning. Here the petitioner did not need a renewal of his license to practice and it may be assumed that he could have continued as a member of his firm whether or not he kept currently informed as to the law of Federal taxation. But he was morally bound to keep so informed and did so in part by means of his attendance at this session of the Institute. It was a way well adapted to fulfill his professional duty to keep sharp the tools he actually used in his going trade or business. It may be that the knowledge he thus gained incidentally increased his fund of learning in general and, in that sense, the cost of acquiring it may have been a personal expense; but we think that the immediate, over-all professional need to incur the expenses in order to perform his work with due regard to the current status of the law so overshadows the personal aspect that it is the decisive feature.

It serves also to distinguish these expenditures from those made to acquire a capital asset. Even if in its cultural aspect knowledge should for tax purposes

be considered in the nature of a capital asset as was suggested in *Welch* v. *Helvering*, *supra*, the rather evanescent character of that for which the petitioner spent his money deprives it of the sort of permanency such a concept embraces.

Decision reversed and cause remanded for the allowance of the deduction.

Note

1. Regs. 118, Sec. 39.23(a)-15(f), disallows, presumably on the theory they are capital expenditures, the following:

> expenses in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, . . . bar examination fees and other expenses in securing admission to the bar, and corresponding fees and expenses incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

Yet paragraph (b) of the same regulation states that the expense of maintaining a building is deductible even though no income is being currently produced and that "income," as the term is used in § 212, comprehends income which the taxpayer "may realize in subsequent taxable years." Why is not a bar examination fee, for example, as much a cost of producing or collecting future income as is the cost of maintaining a presently unoccupied building? After admission to the bar, but before gaining any clients, may the young attorney deduct the salary of an idle stenographer?

2. For somewhat similar expenses that have been disallowed, see: *Cardozo* v. *Commissioner*, 17 T.C. 3 (1951) (professor's expense for European trip for "study and research"); *Osborn* v. *Commissioner*, 3 T.C. 603 (1944) (expenses of a professor "incident to the preparation and publication of scholarly and literary matter from which he did not, and did not expect to, derive a direct or immediate profit, but which he hoped and expected would be a means of demonstrating his ability and attainments to persons in the fields of learning and education and would thus bring him a lucrative position, perhaps as a college president"); *Lampkin* v. *Commissioner*, ¶ 52,173 P-H Memo TC (professor's expenses in connection with doctoral dissertation).

3. For many years the Regulations have provided "Commissions paid in purchasing securities are a part of the cost price of such securities" Regs. 118, Sec 39 24(a)-2(a). This provision of the Regulations was upheld in *Helvering* v. *Winmill*, 305 U.S. 79 (1938), against the contention of the taxpayer that the commissions were compensation for personal services deductible under § 162(a)(1). The Court rested its decision largely on the fact that the provision was a long-standing administrative interpretation that presumably had received Congressional sanction. Even apart from the Regulations, should the commissions have been capitalized rather than deducted? What is the status of finders' fees, brokerage commissions, and similar expenses incurred in connection with other types of property? Should the salary of a corporate purchasing agent be capitalized as part of the cost of the materials he buys? If the president of a corporation spends part of his time planning and supervising the construction of a new plant, should an appropriate portion of his salary be capitalized instead of being deducted?

4. In *Spreckels* v. *Commissioner*, 315 U.S. 626 (1942), the Court upheld another part of Regs. 118, Sec. 24(a)-2(a), providing that commissions paid in selling securities may not be deducted (except by dealers) under § 162(a), but must be treated as an offset to the sales price. (The significance of so doing is that as an offset the commission will reduce the *capital gain* or increase the *capital loss* on the sale rather than reduce ordinary income See Chapter 5.) And in *Davis* v. *Commissioner*, 151 F.2d 441 (8th Cir. 1945), selling commissions were held equally non-deductible under § 212. In *Hirshon* v. *United States*, 116 F. Supp. 135 (Ct. Cl. 1953), a "trader" in securities was allowed to deduct federal excise taxes paid on the sale of securities. The court thought the taxes in question "are so directly connected with the particular capital transactions on which they are imposed, that it would be logical to change the

law so as to require them to be capitalized." Apparently if the Treasury had amended the Regulations to require these taxes to be used as an offset, the court would have honored the amendment. A Bureau ruling, issued after some administrative uncertainty, was held to be insufficient.

(c) What is "Ordinary and Necessary"?

FRIEDMAN v. DELANEY

U. S. Court of Appeals, First Circuit, 1948

171 F.2d 269, cert. den., 336 U.S. 936 (1949)

Before MAGRUDER, Chief Judge, WOODBURY, Circuit Judge, and PETERS, District Judge.

PETERS, District Judge.

In this suit the plaintiff taxpayer seeks to recover the sum of $3,411.47, the amount by which his income tax for the year 1941 was increased by reason of the refusal of the Commissioner to allow the deduction of an item of $5,000, claimed in the income tax return to be a bad debt, but now asserted to be allowable as a business expense or a loss incurred in business. There is no dispute about the facts.

It appears that the plaintiff, Mr. Friedman, a Boston lawyer of long experience, had a valued client in whom he had confidence, one Louis H. Wax, whose proposed composition in bankruptcy required the deposit in court of the sum of $7000. The record shows that Mr. Friedman made this deposit in February, 1938, accompanying it with a caveat to the effect that no part of the money came from Wax or his estate. In November, 1939, Mr. Friedman entered a petition in bankruptcy court alleging "that the money deposited for the proposed composition, which has been abandoned," was deposited by him and was not the property of the bankrupt, and asking that it be ordered returned. The petition was denied in November, 1941, and thereupon Mr. Friedman filed an undertaking that he would not further oppose transfer of the money to the trustee in bankruptcy, at the same time alleging that slightly over $5000 of the amount deposited was his own money.

It seems that the reason Mr. Friedman furnished this money from his own funds in the bankruptcy proceeding was because, in conversations with attorneys for creditors, when he was urging the acceptance of the proposed composition, he had personally assured them that the money to carry it out would be forthcoming. He did this without informing Mr. Wax and without intending to subject him to any legal liability, presumably feeling certain that the money would be obtained from a certain life insurance policy, which he had in his possession. This policy on the life of Wax, payable to his wife, could be pledged for $5000, but when it came to that point Mr. and Mrs. Wax refused to have it so used, which left Mr. Friedman in the breach. Commendably recognizing his moral obligation, in view of the assurances he had given, he paid the money to the clerk of the bankruptcy court.

The question presented is whether the $5000, which the plaintiff in his complaint alleged was "lost by him in connection with the bankruptcy proceedings

of one Louis H. Wax," and which he claimed as a deduction from income in his return for 1941, was wrongfully disallowed by the Commissioner, the plaintiff now claiming that it should have been allowed as an ordinary and necessary expense in carrying on business under Section 23(a) (1), or a loss incurred in business under Section 23(e) (1), of the Internal Revenue Code. . . .

The parties are in agreement that the plaintiff, to recover, must show the applicability of one or the other of those Sections. We agree with the District Court that he has failed to do so.

The plaintiff contends that the loss of the amount in question was due to his keeping his word, which the ethics of his profession, as well as his own conscientiousness compelled him to do, and argues that consequently the payment was made and the loss incurred in his law business, and should have been allowed as a deduction from income under one or the other of the sections referred to. His position is illustrated by his rhetorical question: Is it not part of a lawyer's business to keep his word? It might be answered that it is everybody's business to do so, but that is wide of the mark. We are obliged to inquire whether the circumstances of this loss—no matter how creditably incurred—are clearly within the coverage of either Section referred to. Nor can equitable considerations be allowed to control. The matter of deductions from income. ". . . 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' " *Deputy* v. *DuPont*, 308 U S. 488, 493, 60 S. Ct. 363, 366, 84 L. Ed. 416.

It is necessary to consider the origin of the obligation under which the taxpayer considered himself to be under when he made the payment in question, in determining whether it is a permissible deduction under either Section of the statute. It arose from the gratuitous assurance given attorneys for creditors of Wax by Mr. Friedman that the money for the composition would be forthcoming if they would approve it. In effect, it was the voluntary underwriting of the obligation of another. It was, of course, the duty of the client to furnish the money, not of his attorney. Payment of the $5000. by the attorney was made as a consequence of his undertaking and in pursuance of it and was no less voluntary than the assurance which occasioned it. From any point of view his loss was caused by his voluntary action.

As was said by this Court in the very similar case of *W. F. Young, Inc.*, v. *Commissioner*, 120 F.2d 159, 166,

> Even if the credit and reputation of the taxpayer would have been improved by these payments and even though they would in any way benefit the taxpayer, voluntary payments are not deductible as ordinary and necessary business expenses or losses.

See also *Robinson* v. *Commissioner*, 8 Cir., 53 F.2d 810, 79 A.L.R. 975.

The emphasis placed by the plaintiff upon his moral obligation to keep his professional word should not obscure the fact that the transaction on his part was voluntary from the beginning.

That the circumstances of the taxpayer's payment preclude its being considered either an "ordinary and necessary expense" of his business or a loss incurred in business is clear both from the Regulations promulgated under the Internal Revenue Code and the construction Section 23(a)(1) and Section 23(e)(1) have received by the Courts.

The business expenses covered by the former Section are limited to those described as being "ordinary and necessary"; such as are directly connected with and proximately resulting from carrying it on; those normally originating in a liability created in the course of its operation. *Deputy* v. *DuPont, supra. Welch* v. *Helvering*, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212.

The moral obligation which the taxpayer recognized here, to his financial detriment, was an extra-professional liability which resulted in a loss which is certainly not clearly covered by Section 23(a) (1) according to the accepted construction of that Section.

Nor is the taxpayer in any better case if he claims a deductible loss under Section 23(e) (1). His was not a business loss made in carrying on a law practice. It is obviously no part of a lawyer's business to take on a personal obligation to make payments which should come from his client, unless in pursuance of a previous understanding or agreement to do so. The voluntary nature of the action, resulting in the loss, takes it outside of this Section as well as the other. *W. F. Young* v. *Commissioner, supra. Robinson* v. *Commissioner, supra.*

It should be said that we also see no error in the finding of the District Court that the payment of the $5000—if ever a proper deduction—was deductible only in 1938, when made, and not in 1941, when the taxpayer failed in an attempt to get it back. It is admittedly not a debt due the taxpayer which became "bad." The deposit was made without restriction of destination and was, for all practical purposes, gone and lost to the owner when made.

The action of the District Court in giving judgment for the defendant on the claim in the complaint for the item of $3,411.47 is affirmed. . . .

[CHIEF JUDGE MAGRUDER, whose opinion is omitted, concurred in the result on the basis of certain additional facts that were in the record but which were not regarded as significant by either the district court or the majority of the Court of Appeals.]

Note

1. With the principal case, compare *Dunn & McCarthy, Inc.* v. *Commissioner*, summarized *supra*, p 232. In *Goedel* v. *Commissioner*, 39 B.T.A. 1 (1939), a stock broker was denied a deduction for premiums paid on insurance on the life of the President of the United States, whose death it was feared would disrupt the stock market:

> Where, as here, the expenditure is so unusual as never to have been made, so far as the record reveals, by other persons in the same business, *when confronted with similar conditions*, . . . then we do not think the expenditure was ordinary or necessary, so as to be a deductible business expense within the intendment and meaning of the statute.

See also *Levitt & Sons* v. *Nunan*, 142 F.2d 795 (2d Cir. 1944), 160 F.2d 209 (2d Cir. 1947).

2. In *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 373-374 (1945), the Supreme Court said:

> Sec. 23(a)(2) is comparable and *in pari materia* with Sec. 23(a)(1), authorizing the deduction of business or trade expenses. Such expenses need not relate directly to the production of income for the business. It is enough that the expense, if "ordinary and necessary," is directly connected with or proximately results from the conduct of the business. . . . The effect of Sec. 23(a)(2) was to provide for a class of non-business deductions coextensive with the business deductions allowed by Sec. 23(a)(1), except for the fact that, since they were not incurred in connection

with a business, the section made it necessary that they be incurred for the production of income or in the management or conservation of property held for the production of income.

. . . Section 23(a)(2) thus treats the trust as an entity for producing income comparable to a business enterprise, and like Sec. 23(a)(1) permits deductions of management expenses of the trust, even though the particular expense was not an expense directly producing income.

In *Abbott* v. *Commissioner*, 38 B.T.A. 1290 (1938), an attorney who regularly acted as a paid trustee was held to be entitled to a deduction for an amount paid in settlement of an asserted liability arising from his acts as a trustee. See also *C. L. Baumann & Co.* v. *Marcelle*, 203 F.2d 459 (2d Cir. 1953). In light of the Supreme Court's words in the *Bingham* case, should a trustee not regularly engaged in such capacity be allowed to deduct an amount paid to settle such a liability? *Commissioner* v. *Heide*, 165 F.2d 699 (2nd Cir. 1948); *Commissioner* v. *Josephs*, 168 F.2d 233 (8th Cir. 1948); *Macy* v. *Commissioner*, 19 T.C. 409 (1952).

3. Can a "gift" be a business expense? Regs. 118, Sec. 39.23(o)-1(e); *Smith* v. *Commissioner*, 3 T.C. 696 (1944); *Limerick* v. *Commissioner*, ¶ 50,144 P-H Memo. TC, *Bateman* v. *Commissioner*, 34 B.T.A. 351 (1936). What about dues to a social club? *Lee* v. *Commissioner*, ¶ 46,079 P-H Memo TC.

4. Entertainment expenses may constitute a substantial part of a company's expenses. Is there any limitation on the amount which may be deducted? May a limitation be imposed because of the character of the "entertainment"? *Haverhill Shoe Novelty Co.* v. *Commissioner*, 15 T.C. 517 (1950).

PATTON v. COMMISSIONER

U. S. Court of Appeals, Sixth Circuit, 1948
168 F.2d 28

Before HICKS, MCALLISTER and MILLER, Circuit Judges.

HICKS, Circuit Judge.

Respondent found a deficiency in the income and victory taxes for 1943 of petitioner, James F. Patton, in the sum of $16,561.12, and of petitioner, Vincent Patton, in the sum of $16,361.80 The cases were consolidated for hearing before the Tax Court and here. The Tax Court confirmed the deficiency assessments and we are asked to review its decision.

The cases arose under I.R.C, Sec. 23(a) (1) (A), which in so far as is applicable, is printed in the margin.[1]

During the calendar year 1943 petitioners were partners doing a general jobbing business under the firm name of "Patton Company, Cleveland, Ohio," and one William Kirk was an employee of the firm. The partnership claimed deductions for 1943 for compensation of $46,049.41 paid to Kirk. The Commissioner determined that $13,000 00 constituted reasonable compensation for him for that year and disallowed the deductions claimed above that amount. The Tax Court sustained the Commissioner.

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[1] Sec 23 Deductions from gross income.

In computing net income there shall be allowed as deductions

(a) . . . Expenses,—

(1) Trade or business expenses.—

(A) In General—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, *including a reasonable allowance for salaries or other compensation for personal services actually rendered;* . . . (Italics ours.)

Kirk kept the books and records of the partnership and rendered such other clerical and routine services as the office work required. He generally worked without assistants. Petitioners complain that the Tax Court erred in finding that Kirk kept the books on a cash basis, that his duties as a bookkeeper entailed little effort, that petitioners' production was practically supervised by Government inspectors, that Kirk was paid 10% of the net sales of the partnership, that the payments to him formed a basis for tax reduction, that he was to receive 10% of net sales so long as 10% commission, plus the $2,400.00 minimum, did not exceed 22½% of net profits.

They also complain that the Tax Court erred in failing to make findings that the petitioners and Kirk were unrelated and had no common business interests other than that created by the contract, that Kirk devoted long hours to the business, that the contract was of the "profit-sharing" type and formed a measuring rod by which Kirk's earnings were to be determined; that the court failed to make findings of the educational background of petitioners and give effect thereto. . . .

At this late date it is an elementary proposition, needing no citation of authorities to support it, that this court is without power to make findings of fact. Its function [§ 7482(c)(1), '54 Code] is to determine whether the decision of the Tax Court is "in accordance with law" If it is, an affirmance is in order; otherwise the court may modify or reverse the decision. And in determining this question, the court is limited to ascertaining whether there was evidence to support the findings and decision of the Tax Court We may not make an independent determination of the issues before the Tax Court nor pass upon the weight of the evidence or consider conflicting evidence nor choose between possible inferences that may arise.

The Tax Court found the following facts: Prior to July 1, 1940, petitioner, James F. Patton, operated the machine shop as an individual, during which time his business was small. At times he had no employees and did all the work himself. At other times the work required additional help. At times his son, Vincent, assisted him, although Vincent had full time employment elsewhere. About 1937 James F. Patton employed Kirk to do his office work. Kirk had a grammar school education and a two years' commercial course in high school. From 1893 to 1919 he engaged in clerical work and following that, he operated a small trucking business until 1929. From then, until his employment by James F. Patton he had no regular employment. From 1919 to 1941 his earnings were not sufficient to require the filing of tax returns. From 1937 to 1940 Kirk's compensation was approximately as follows: For 1937, $939.00; for 1938, $1,230.00; for 1939, $1,385.00; for 1940, $1,855.00

On July 1, 1940, James F. Patton and his son Vincent formed a partnership and shortly thereafter James F. turned over the affairs of the partnership to Vincent. Up to December 17, 1940, the partnership, called The Patton Company, did job work for general customers, but on that date The General Motors Corporation began sending work to the Company in such volume that its productive capacity was absorbed by the new customer.

On January 2, 1941, petitioners contracted in writing with Kirk whereby he was to receive a minimum salary of $2,400.00 a year until such time as 22½% of the net profits exceeded $2,400.00. In such event the contract provided that Kirk

was to receive 10% of the net sales for as long as that percentage, plus the $2,400.00 basic salary, did not exceed 22½% of the net profits.

The gross sales from 1941 to 1943 were, for 1941, $179,050.00; for 1942, $365,609.53; for 1943 [the year involved here] $460,494.06. Kirk kept the books on a cash basis in a simple way. He recorded in a cash book all receipts and disbursements and at the end of each month prepared two summary sheets, one showing total receipts and disbursements of each class and the other showing materials purchased. At the end of each year the summary sheets showing totals for each month and year were used by an accountant who translated them to an accrual basis in preparing income tax returns. Kirk kept a ledger and did the billing, which required little effort because substantially all of the Company's work was for General Motors. He prepared the payrolls, kept social security records and made quarterly social security reports. He kept petitioner Vincent Patton informed of the bank balances and transmitted to shop foremen information from General Motors as to the orders it desired to be finished first. He spoke to insurance salesmen before purchases of insurance were approved by Vincent. About five times in 1942-3 he called upon the appropriate agents for approval for wage increases for employees. Kirk was not a partner in the Patton Company nor related to either of the partners.

The case strips to one question: whether, as determined by the Commissioner, $13,000.00 was reasonable compensation to Kirk for 1943. We are dealing with a pure question of fact. *Wilmington Co.* v. *Helvering*, 316 U.S. 164, 62 S. Ct. 984, 986, 86 L. Ed. 1352. In the *Wilmington* case, *supra*, the court said:

> It is the function of the Board, not the Circuit Court of Appeals, to weigh the evidence, to draw inferences from the facts, and to choose between conflicting inferences. The court may not substitute its view of the facts for that of the Board. Where the findings of the Board are supported by substantial evidence they are conclusive.

In the proceedings before the Tax Court the presumption is that the Commissioner was right and petitioners have the burden of proving that his determination was wrong. We think that the findings of the Tax Court are supported by substantial evidence and an affirmance must result. There is no hard and fast rule by which reasonableness of compensation may be determined by the Tax Court. Every case must stand or fall upon its own peculiar facts and circumstances. Among other factors to be considered by that Court are The nature of the services to be performed, the responsibilities they entail, the time required of the employee in the discharge of his duties, his capabilities and training, and the amount of compensation paid in proportion to net profits. An exclusive function of the Tax Court is the determination of the weight and credibility to be given to the witnesses.

We think that petitioners have failed to carry the burden, which the law imposes upon them, to make out their case by clear and convincing evidence. *Atlas Plaster & Fuel Co.* v. *Comm'r*, 6 Cir., 55 F.2d 802, 803; *Tracy* v. *Comm'r*, 6 Cir., 53 F.2d 575, 579; and *Guarantee Bond & Mortgage Co.* v. *Comm'r*, 6 Cir., 44 F.2d 297, 298. Probably one of the most important factors in determining the reasonableness of compensation is the amount paid to similar employees by similar concerns engaged in similar industries. The petitioners introduced no evidence upon this subject. Moreover, it occurs to us that the books of the partnership

kept by Kirk would have disclosed to a great extent the nature and volume of his work and his capabilities to perform it, but neither the books nor any verified entries therefrom were introduced by petitioners. There is of course a presumption that as between the parties to the contract the compensation agreed to be paid was reasonable. But, as between petitioners and the Commissioner, such a presumption is not controlling in a controversy of this nature before the Tax Court. *Botany Worsted Mills* v. *United States*, 278 U.S. 282, 292, 49 S. Ct. 129, 73 L. Ed. 379.

Affirmed.

McAllister, Circuit Judge (*dissenting*).

According to Section 23 of the Internal Revenue Code, to which reference has been made, petitioners are entitled to a deduction in their taxes for all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on" their business, "including a reasonable allowance for salaries or other compensation for personal services actually rendered." The issue is whether the compensation which was paid to Kirk, in accordance with his contract of employment, was a reasonable allowance. As is said in the prevailing opinion, there is a presumption that, as between the parties to the contract, the compensation agreed to be paid was reasonable. But it is declared that as between petitioners herein and the Commissioner, such a presumption is not controlling in a controversy of this nature before the Tax Court, and *Botany Worsted Mills* v. *United States*, 278 U.S. 282, 292, 49 S. Ct. 129, 133, 73 L. Ed. 379, is cited as authority to sustain this conclusion.

It does not seem to me that the *Botany Mills* case controls the controversy before us. There, the stockholders of a corporation adopted a bylaw providing for the payment of more than 50% of the annual net profits to the members of the board of directors, for their services, in addition to their regular annual salaries of $9,000 each. In 1917, the tax year there in controversy, the amount paid out of net profits to the board of directors was $1,565,739.39, or a payment to each director of $156,573.93, in addition to his salary. Under a statute, similar in phrasing to the one before us, providing for deductions of all "the ordinary and necessary expenses paid within the year in the maintenance and operation of its business," 39 Stat. 756, the court held that this amount so greatly exceeded the amounts which are usually paid to directors for their attendance at meetings of the board and the discharge of their customary duties, as to raise a strong inference that the "amount paid to the directors was *not in fact compensation for their services, but merely a distribution of a fixed percentage of the net profits* that had no relation to the services rendered." (Emphasis supplied.) The *Botany Mills* case cites three other cases, hereinafter briefly discussed, that seem to me to elucidate the reason for the court's decision.

In *Jacobs & Davies* v. *Anderson*, 2 Cir., 228 F. 505, 506, it appeared that two men, who had been partners, incorporated their business a few months before the enactment of the Corporation Tax Act of 1909, and forthwith entered into a contract with the corporation to devote their services to the business, for stated salaries, and with the further provision that the net surplus profits should be divided between them on the basis of their stock holdings. The court held that the payments of net profits to the parties on the basis of their ownership of stock

were not payments of compensation, but were merely the profits of the business, subject to tax. The court said that the amount paid out in dividends could not be deducted for the purpose of ascertaining the net income of the corporation. "The distribution of surplus profits was not an ordinary and necessary expense paid in the maintenance and operation of the business."

In *United States* v. *Philadelphia Knitting Mills Co.*, 3 Cir., 273 F 657, 658, the court said·

> As the board of directors is charged with the duty and clothed with the discretion of fixing the salaries of the corporation's officers, the Government has no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little. But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the Government may inquire whether the amount paid is salary or something else. Admittedly the Government has a right to collect taxes on net income of a corporation based on profits after all ordinary and necessary expenses, including salaries, are paid. It has a right, therefore, to attack the action of a board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances, the whole or some part of it is not salary at all but is profits diverted to a stockholding officer under the guise of salary and as such is subject to taxation.

In *Becker Bros.* v. *United States*, 2 Cir., 7 F.2d 3, 6, where the general manager of a corporation owned 240 out of 250 shares of its stock, and entered into a contract with the corporation providing that his salary should be 85% of the net annual profits, the court said:

> There can be no doubt that the corporation was entitled to deduct from the income it received all the ordinary and necessary expenses incurred in carrying on its business, including a reasonable compensation to its officers and employees. But the salaries which are paid in order to constitute an allowable deduction must be a reasonable and fair compensation for the services rendered. The expenses which can be deducted are the "ordinary and necessary expenses." If a corporation sees fit to pay its employees extraordinary, unusual, and extravagant salaries, distributing the profits of the business *in the guise of salaries to its officers, who hold the stock and control its affairs*, such salaries manifestly do not constitute the "ordinary and necessary expenses" of the business, which can be deducted under the statute. The government is not bound or concluded either by any resolution which the corporation adopts, or by its method of keeping its books, upon the question as to whether any particular payment is a salary payment or a division of surplus. (Emphasis supplied.)

In all of these cases, the amounts were paid to officers who were really the beneficial owners of the corporation and who controlled its action in contracting for and paying them the unusually high salaries based upon net profits. The reasons the courts have held such salaries were not deductible as "ordinary and necessary expenses," were because they were not, in fact, compensation, but merely a distribution of profits; that such profits, divided on the basis of stock holdings, were not payments of compensation, that the claimed salaries were not salaries at all, but profits diverted to stock holding officers under the guise of salaries; and that a distribution of profits "under the guise of salaries" to officers who held the stock of a company and controlled its affiairs, is not an ordinary and necessary expense, within the meaning of the statute.

In this case, Kirk was not an owner or part owner of the company, directly or indirectly. His contract of employment, providing for a salary, based on profits, was not a distribution of profits under the guise of a salary. There is no question that the contract of employment was bona fide. As was said in *United States* v.

Philadelphia Knitting Mills Co., supra, the Government has no right to inquire into and determine whether the amount of the salary was proper, or whether it was too much or too little, but only "whether the amount paid is salary or something else."

Although much importance is seemingly attached by the Government to the fact that, before the contract of employment was entered into between Kirk and petitioners, his salary for the preceding four years was only $939, $1,230, $1,385, and $1,855, the Commissioner finally allowed a deduction on the basis of a salary to Kirk in the amount of $13,000. It can easily be perceived from the evidence that this was a purely arbitrary allowance on the part of the Commissioner. If it was based on the previous earnings of Kirk or upon what he actually did, it was obviously excessive. If it was arrived at by taking the contract for his services into consideration, it was clearly inadequate. It is impossible to escape the conclusion that the Commissioner based his allowance on the ground that the amount of compensation provided by the contract eventually turned out to be too high, merely because the profits during the years in question were so great. No such arbitrary determinations are valid, either in administrative decisions or in court adjudications. The decision that the amount provided by the contract of employment was too high was, as has been stated by the courts, no business or concern of the Government. The decisive question is whether the amount paid to Kirk was salary or a distribution of profits paid under the guise of salary. It was not a distribution of profits, for Kirk has no interest in the company.

It is admitted in this case that the amount paid to Kirk was salary, and there is nothing in the case to overcome the presumption that such compensation was reasonable. In my opinion, the partners were entitled to deduct the payment of such salary as an ordinary and necessary expense incurred during the taxable year, and the decision of the Tax Court to the contrary should be reversed.

Note

1. Did the court find that Kirk's contract was unreasonable when made, or only that his 1943 salary (however computed and despite its contingent nature), was greater than the value of his 1943 services? Note Regs. 118, Sec. 39.23(a)-6 (b)(2). Relying on this provision of the Regulations, the Court of Claims allowed a corporation to deduct contingent compensation that came to $177,000 as a result of war contracts, although when the contract was made the previous year it had been estimated that the officer would get $40–50,000 under the contract. Having concluded that the contract was reasonable when made, the court apparently felt that the amount actually paid under it was irrelevant. *Rogers, Inc.* v. *United States*, 93 F. Supp. 1014 (Ct. Cl. 1950).

2. It has been shown that originally the phrase here involved—"including a reasonable allowance for salaries or other compensation for personal services actually rendered"—was intended not as a *limitation* on § 162(a)'s blanket allowance of "all ordinary and necessary business expenses," but rather as an authorization to deduct an additional allowance for services where the salary *actually* paid or incurred therefor was inadequate. Griswold, "New Light on 'A Reasonable Allowance for Salaries,'" 59 *Harv. L. Rev.* 286 (1945). The contrary belief, that the phrase was intended to restrict rather than to enlarge what would otherwise be deductible as a business expense, however, is apparently imbedded beyond correction. See *Walts, Inc.* v. *Commissioner*, ¶ 47,003 P-H Memo TC; and note that the 1954 Code reenacted the phrase after innumerable cases had interpreted it as a limitation on the deduction of business expenses. Its principal function has been to disallow so-called salaries that are in reality nondeductible dividends to stockholder-employees or indirect gifts by stockholders to members of their families. Such disguised dividends could of course be disallowed

without the use of the "reasonable allowance" test, on the theory that they are not "expenses" at all.

The *Patton* case is unusual in this area in that the employee whose compensation is disallowed was neither a proprietor of the enterprise nor the relative of one. Wholly extravagant salaries are unlikely to be found in such a situation except where tax rates are so high as to destroy any incentive to be economical with employees. Another occasion for wild generosity toward an employee who is neither a stockholder nor a stockholder's relative is the closely held corporation with one important "outside" executive who owns no stock. If the stockholder-executives are receiving extravagant "salaries," it may be necessary to give the outsider a slice of the melon in order to preserve intra-company harmony. See *Builders Steel Co.* v. *Commissioner,* 197 F.2d 263 (8th Cir. 1952).

One other area of possible application for the "reasonable" compensation doctrine is the publicly-held corporation whose officers have control through the proxy machinery and are unduly open-handed in compensating themselves wtih corporate funds. But the courts have been reluctant to hold compensation unreasonable in stockholders' derivative actions, see *Heller* v. *Boylan,* 29 N.Y.S.2d 653 (1941), aff'd 32 *id.* 131, and this may explain why there has apparently been no attempt to disallow for tax purposes compensation paid by publicly-held corporations. What would be the probative effect of a disallowance of compensation in a tax case on a subsequent stockholder's suit for breach of the fiduciary obligation?

3. If the compensation is paid by a corporation to a stockholder-employee, is the unreasonable part necessarily a "disguised dividend" that must be repaid if under state law the corporation was not financially able to declare a dividend? See *Leach* v. *Commissioner,* 21 T.C. 70 (1953). What are the tax consequences of returning the "excessive" portion of the compensation? Schlaudt, "Returnable Compensation Arrangements in Closely Held Corporations," *8th Annual N.Y.U. Inst. on Fed. Taxation* 724 (1950).

4. Whether a payment is "compensation" or a disguised dividend is one of the most commonly litigated tax questions, and the lack of standards makes for constant friction between taxpayer and government in this field. Almost every successful closely held corporation is a potential target for disallowance. The litigated cases, numerous as they are, undoubtedly represent only a small fraction of the disputes, since the factual nature of the question and the presumption of correctness enjoyed by the Commissioner both encourage settlements to avoid the cost and uncertainty of lawsuits. On the question of standards, see Regs. 118, Sec. 39.23(a)-6, Griswold, "The Deduction of 'A Reasonable Allowance for Salaries'—The Undefined Power of the Commissioner," 56 *Harv. L. Rev.* 997 (1943); and for details of litigated cases, see Miller, "What the Tax Court Wants to Know in a Reasonable Compensation Case," 79 *J. Acc'y* 366 (1945); Wolder, "Facts and Figures on Reasonable Compensation," 24 *Taxes* 150 (1946).

5. Section 162(a)(1) in terms requires only that compensation be "reasonable." There is no such explicit requirement for other business expenses under § 162(a), for non-trade and non-business expenses under § 212, or for losses under § 165. Must these other deductions nevertheless be "reasonable" in amount? *Commissioner* v. *Lincoln Electric Co.,* 176 F.2d 815 (6th Cir. 1949), *Place* v. *Commissioner,* 17 T.C. 199, 203, (1951), aff'd p c. 199 F.2d 373 (6th Cir. 1952), cert denied 344 U.S. 927 (1953); Kilcullen, "Is Reasonableness a Requirement of Non-Compensation Expenses? " *9th Annual N.Y.U. Inst. on Fed. Taxation* 863 (1951).

LILLY v. COMMISSIONER

Supreme Court of the U. S, 1952

343 U.S. 90

MR. JUSTICE BURTON delivered the opinion of the Court.

Petitioners, Thomas B. Lilly and Helen W. Lilly, his wife, were engaged in the optical business in North Carolina and Virginia in 1943 and 1944. Pursuant to

agreements reflecting an established and widespread practice in that industry in those localities, they paid to the respective doctors, who prescribed the eyeglasses which they sold, one-third of the retail sales price received for the glasses. The question here is whether such payments were deductible by petitioners as ordinary and necessary business expenses under § 23(a)(1)(A) of the Internal Revenue Code. For the reasons hereafter stated we hold that they were.

Petitioners owned and operated as partners the City Optical Company with offices in Wilmington, Fayetteville and Greensboro, North Carolina, and Richmond, Virginia. Petitioner Helen W. Lilly also owned and operated the Duke Optical Company in Fayetteville.

Since long before 1922 when Thomas B. Lilly established his business in Wilmington, eye doctors, in that locality and to a substantial extent throughout comparable communities in North Carolina, Virginia and elsewhere in the United States, not only examined their patients' eyes and prescribed glasses, but also sold them the glasses. The doctors bought the frames and lenses at wholesale, prepared and fitted the glasses to the patients and sold the glasses at a profit.

Lilly and other opticians offered to fill the prescriptions for the doctors and to supply and fit the frames to the patients. To compensate the doctors for their loss of profit on the sales, the opticians generally paid the doctors one-third of the retail price of the glasses. While information as to this arrangement was not volunteered to the patients, it was freely disclosed on inquiry. The doctors made it a practice to ask their patients to bring in their new glasses for verification of the prescriptions and to enable the doctors to see that the frames were properly fitted. Without further charge, they made whatever reexaminations and modifications were needed.

For income tax purposes, petitioners treated their payments to the doctors as ordinary and necessary expenses of carrying on business and deducted them from their gross incomes. The doctors, in turn, included them in their taxable gross incomes. However, in 1943 and 1944, the respondent Commissioner of Internal Revenue disallowed these deductions in petitioners' returns and thereby increased petitioners' taxable income as follows:

	City Optical Company	*Duke Optical Company*
1942	$57,063.45	
1943	61,601.95	$6,568.87
1944	60,021.65	4,798.35

The Tax Court sustained the Commissioner on the ground that the payments to the doctors were contrary to public policy. One judge dissented. 14 T.C. 1066. The resulting tax deficiencies totaled $124,107.78. The Court of Appeals affirmed. 188 F.2d 269. We granted certiorari, 342 U.S. 808, 72 S. Ct. 45, to resolve the disputed question of statutory construction and to pass upon the application to these facts of the principles announced in *Textile Mills Corp. Securities* v. *Commissioner of Internal Revenue*, 314 U.S. 326, 62 S. Ct. 272, 86 L. Ed. 249, and *Commissioner of Internal Revenue* v. *Heininger*, 320 U.S. 467, 64 S. Ct. 249, 88 L. Ed. 171.

The facts are not in dispute. The payments to the doctors were made by peti-

tioners monthly in the regular course of their business. Under the long-established practice in the optical industry in the localities where petitioners did business, these payments, in 1943 and 1944, were normal, usual and customary in size and character. The transactions from which they arose were of common or frequent occurrence in the type of business involved. They reflected a nationwide practice. Consequently, they were "ordinary" in the generally accepted meaning of that word. See *Deputy* v. *Du Pont,* 308 U.S. 488, 495, 60 S. Ct. 363, 367, 84 L. Ed. 416; *Welch* v *Helvering,* 290 U.S. 111, 114, 54 S. Ct. 8, 9, 78 L. Ed. 212.

The payments likewise were "necessary" in the generally accepted meaning of that word It was through making such payments that petitioners had been able to establish their business. Discontinuance of the payments would have meant, in 1943 or 1944, either the resumption of the sale of glasses by the doctors or the doctors' reference of their patients to competing opticians who shared profits with them. Several doctors testified that they had recommended petitioners and petitioners' competitor, the American Optical Company, simultaneously. Both were sharing profits with the doctors on substantially the same basis. If either had stopped making the payments while the other continued them, there is no reason to doubt that the doctors thereafter would have omitted their recommendation of the nonpaying optician. In 1943 and 1944 the continuance of these payments was as essential to petitioners as were their other business expenses. As has been said of legal expenses under somewhat comparable circumstances, "To say that this course of conduct and the expenses which it involved were extraordinary or unnecessary would be to ignore the ways or conduct and the forms of speech prevailing in the business world." *Commissioner of Internal Revenue* v. *Heininger,* 320 U.S. 467, 472,[1] 64 S. Ct. 249, 253, 88 L. Ed. 171.

There is no statement in the Act, or in its accompanying regulations, prohibiting the deduction of ordinary and necessary business expenses on the ground that they violate or frustrate "public policy."

The Tax Court in the instant case made no finding of fact that the payments to the doctors were not ordinary and necessary business expenses. It sustained the Commissioner's disallowance of their deductibility because it held that, as a matter of law, the contracts under which the payments were made violated public policy.[2]

We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business expenses within the meaning of § 23(a)(1)(A).

In *Textile Mills Securities Corp.* v. *Commissioner of Internal Revenue,* 314

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[1] ". . . Without this expense, there would have been no business Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary." *Heininger* v. *Commissioner of Internal Revenue,* 7 Cir., 133 F.2d 567, 570

[2] "We conclude that the payments under the contracts between the two optical businesses, composed of petitioners, and the oculists are not deductible as ordinary and necessary expenses *because* the contracts under which these payments were made violated public policy." (Emphasis supplied) 14 T.C. at page 1086.

U.S. 326, 62 S. Ct. 272, 86 L. Ed. 249, this Court accepted an interpretation of that section by a Treasury Regulation which disallowed the deduction of certain expenditures for lobbying purposes. In doing so, the Court referred to the fact that some types of lobbying expenditures had long been condemned by it, and that the interpretative regulation had itself been in effect many years with congressional acquiescence. The instant case does not come within that precedent.

In *Commissioner of Internal Revenue* v. *Heininger*, 320 U. S. 467, 64 S. Ct. 249, 88 L. Ed. 171, this Court was asked to go further and to disallow certain attorneys' fees and other legal expenses. They were reasonable in amount and had been lawfully incurred by a licensed dentist (1) in resisting the issuance by the Postmaster General of a fraud order which would have destroyed the dentist's business and (2) in connection with subsequent proceedings on judicial review of the same controversy. While the services resulted in an injunction which stayed the order during the time that the taxable income in question was received, the final result of the litigation was unsuccessful for the taxpayer. Nevertheless, the expenditures were permitted to be deducted as ordinary and necessary expenses of the taxpayer's business. The opinion in that case reviews the position of the Bureau of Internal Revenue, the Board of Tax Appeals and the federal courts. *Id.*, 320 U.S. at pages 473-474, 64 S. Ct. at page 253. It refers to the narrowing of "the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences *might not frustrate sharply defined national or state policies* proscribing particular types of conduct." (Emphasis supplied.) *Id.*, 320 U.S. at page 473, 64 S. Ct. at page 253. It concludes that the

> language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible. . . . If the respondent's litigation expenses are to be denied deduction, it must be because allowance of the deduction would frustrate the sharply defined policies of 39 U.S.C. §§ 259 and 732, 39 U.S.C.A. §§ 259, 732, which authorize the Postmaster General to issue fraud orders. *Id.*, 320 U.S. at page 474, 64 S. Ct. at page 254.

Neither that decision nor the rule suggested by it requires disallowance of petitioners' expenditures as deductions in the instant case.

Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as "ordinary and necessary" expenses under § 23(a)(1)(A) when they "frustrate sharply defined national or state policies proscribing particular types of conduct", *supra*, nevertheless the expenditures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them. In 1943 and 1944 there were no such declared public policies proscribing the payments which were made by petitioners to the doctors.

Customs and the actions of organized professional organizations have an appropriate place in determining in a factual sense what are ordinary and necessary expenses at a given time and place. For example, they materially affect competitive standards which determine whether certain expenditures are in fact ordinary and necessary. Evidence of them is admissible on that issue. They do not, however, in themselves constitute the "sharply defined national or state policies" the frustration of which may, as a matter of law, preclude the deductibility of an expense under § 23(a)(1)(A).

We voice no approval of the business ethics or public policy involved in the payments now before us. We recognize the province of legislatures to translate progressive standards of professional conduct into law and we note that legislation has been passed in recent years in North Carolina and other states outlawing the practice here considered. We recognize also the organized activities of the medical profession in dealing with the subject. A resulting abolition of the practice will reflect itself in the tax returns of the parties without the retroactive hardship complained of here.[3]

The judgment of the Court of Appeals is reversed and cause remanded with directions to remand to the Tax Court with instructions to set aside its judgment insofar as it is inconsistent with this opinion.

It is so ordered.

Judgment of Court of Appeals reversed and cause remanded to Tax Court with instructions.

MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case.

Note

1. Note the Supreme Court's statement that there must be "some governmental declaration" of the "sharply defined national or state" policy allegedly frustrated by the deduction The Court of Appeals for the Fourth Circuit said of the payments.

> A doctor owes the duty of undivided loyalty to his patients, and a contract which violates this duty is unenforceable and opposed to public policy. . . . Surely, the doctor is assuming an utterly inconsistent position when he recommends an optician without disclosing that he is being paid for the recommendation. This corrupt practice obviously involves, or tends to promote, serious evils: (1) the prescription by the doctor of glasses where not actually necessary; (2) more expensive lenses than really needed; (3) recommendation of an inferior optician, (4) artificial increase in the cost of glasses by the inclusion of the physician's commission, for which the physician affords no value to the patient. . . . We hold, since these kickbacks corrupt the fiduciary relationship between physicians and patient and result in a violation of the duty of loyalty, they are opposed to public policy. . . . (*Lilly* v. *Commissioner*, 188 F.2d 269, 271 (4th Cir. 1951.))

Why is this not a "governmental declaration" of a "sharply defined" state policy? Would a legislative resolution, condemning the practice but attaching no sanctions, warrant a denial of the deduction? Would a declaration by the *governor* meet the Supreme Court's requirement?

The Canons of Legal Ethics permit a "forwarding fee" to be paid only if justified by the service performed by the forwarding attorney. See Drinker, *Legal Ethics* (1953), pp. 186–188. If a violation of the Canons may lead to disciplinary action by the court, does improper fee-splitting violate a state policy evidenced by a governmental declaration?

In *Salt* v. *Commissioner*, 18 T.C. 182 (1952), a taxpayer was allowed to deduct as a business expense legal fees paid for advice in connection with a subpoena served by the House Committee on Un-American Activities. The taxpayer was a writer in the motion picture industry and was subpoenaed during the Committee's investigation of that industry. He was not called upon to testify. The Bureau argued that the deduction should be denied on the ground that the fees (part of a fund to which others, who refused to answer questions and were cited for contempt, also contributed) were "for

[3] The payments made to the doctors in the instant case, and disallowed as deductions by the courts below, amounted to between 56% and 72% of petitioners' taxable business income. The income thus taxed had been transferred long ago to the doctors and they had paid their income tax on it.

the purpose of directly opposing and resisting the actual investigative function of a Congressional committee." The court found that the taxpayer did not have this intention and allowed the deduction as a business expense on the ground that the investigation was calculated to affect the future of the motion picture industry and specifically of his employment therein.

2. After the *Lilly* case was decided, the Bureau announced that payments made by a surgeon to other physicians for referring patients to him could be deducted if customary in the profession, helpful in obtaining business, and not in violation of any governmentally declared national or state policy. I.T. 4096, 52-2 C.B. 91. The American College of Surgeons has condemned the practice of fee-splitting and has urged the Bureau to disallow deductions for such payments. The Regulations provide that the cost of illegal operations or drugs may not be deducted as medical expenses under § 213. Regs. 118, Sec. 39.23(x)-1(d)(1). Is this restriction warranted if only the physician or pharmacist, and not the patient-taxpayer, has violated the law?

3. The Court says that "the actions of organized professional organizations have an appropriate place in determining in a factual sense what are ordinary and necessary expenses at a given time and place." Suppose the local morticians officially frown on neon lights or the bankers condemn the luring of customers with free piggy banks—should a deduction be denied to the taxpayer who flouts custom on the ground that the expense is not "ordinary and necessary?"

4. See Schwartz, "Business Expenses Contrary to Public Policy. An Evaluation of the *Lilly* Case," 8 *Tax. L. Rev.* 241 (1953).

5. The status of income from an illegal activity or business has already been examined. *Supra*, p. 101. In *United States* v. *Sullivan*, 274 U.S. 259, 264 (1927), the Court (through Mr. Justice Holmes) said of the argument that if a bootlegger must file a return he would be entitled to deduct bribes as expense of his calling: "This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it." In *Comeaux* v. *Commissioner*, 10 T.C. 201 (1948), the Tax Court distinguished between the "legal" expenses of an illegal business and its "illegal" expenses. "Protection" payments were put in the latter category, salaries in the former. But should wages be deductible if under local law the employees are co-conspirators or accessories? Should rentals be deductible if the use of the premises (*e.g.*, for gambling) is itself unlawful? No doubt at least to some extent the employees and landlord are being compensated for the risks of violating the law. Would the *Rossman* case, *infra*, classify these payments in part or in whole as payments whose deductibility would frustrate sharply defined statutory policies? In *Fuller* v. *Commissioner*, 213 F.2d 102 (10th Cir. 1954), a taxpayer selling liquor illegally in Oklahoma was allowed the cost of his whiskey as part of cost of goods sold, except that the cost of whiskey confiscated by the state was eliminated. In *Clark* v. *Commissioner*, 19 T.C. 48 (1952), an operator of illegal slot machines was not allowed to deduct payments made to the city under an arrangement with the mayor by which he was required to pay $25 per machine per month.

In a speech before the American Bar Association, August 27, 1953, Attorney General Brownell said:

> It seems anomalous that a person engaged in a business which is admittedly illegal may take a deduction for "ordinary and necessary expenses" incurred in the business. As either a legal or practical matter, I can see nothing ordinary or necessary in expenses incurred in long distance phone calls made to place bets or make layoffs; automobile expenses for collecting numbers or delivering "dope," rent for houses used for gambling or other vice. But even if they are "ordinary" expense, there is certainly nothing "necessary" about them.
>
> Our policy will henceforth be to disallow all deductions for expenses incurred in illegal enterprise, and the Treasury Department has promised us its fullest cooperation. While there is some judicial confusion among the lower courts as to the right under existing law to disallow such expenses, the Supreme Court has never squarely passed on the question. In *Lilly* v. *Commissioner*, 343 U.S. 90, the Court

indicated that "it could be argued," and I believe the argument can and should be made.

But see Paul, "The Use of Public Policy by the Commissioner in Disallowing Deductions," 1954 *So. Calif. Tax Inst.* 715.

J. ROSSMAN CORP. v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1949
175 F.2d 711

Before L. HAND, Chief Judge, and CLARK and FRANK, Circuit Judges.

L. HAND, Chief Judge.

The petitioner appeals from an order of the Tax Court, in banc, seven judges dissenting, assessing a deficiency in its excess profits tax for the year 1943. Only one question is involved· whether the taxpayer was entitled to deduct a payment made to the United States during the year in question in circumstances to be stated The taxpayer was a "converter" of "greige goods," which shrink or stretch in the process of dyeing to an extent not determinable in advance. During the period in question its prices were fixed upon a "cost plus" basis by regulations promulgated under the Emergency Price Control Act of 1942, 50 U.S.C.A. Appendix, § 901 *et seq.*, of which the apposite one provided that a "converter" might fix a "working allowance shrinkage" in his contracts with his customers, but that this must be limited to a maximum, which for the purpose of this appeal it is not necessary to describe. In May, 1943, the taxpayer learned that, because it had accepted and charged the shrinkage figures given it by the "finishers" to whom it had sent the goods to be dyed, it had unwittingly overcharged its customers by claiming larger shrinkages than the regulation allowed. Although the Office of Price Administration had not started any investigation of the taxpayer's charges and had not until then undertaken to investigate them, its president asked the advice of the Office as to what he should do. The official to whom he went suggested that he return the overcharges to the customers, but this was altogether impracticable. In the first place, it involved going over more than 200 accounts, and, more important, the taxpayer's customers were not entitled to the overcharges anyway, for they had passed them on to the consumers. For these reasons the official consented that the taxpayer should settle the whole matter by paying the gross overcharge to the United States in one sum and this it did on May 17, 1943. That payment is the disputed deduction. Nobody suggests that the overcharge was deliberate; but the Tax Court did find that it was "not too clear from the evidence that the overcharges in question might not have been avoided, if the petitioner had adopted other more appropriate measures."

Three questions arise. (1) whether the payment can be regarded as a "penalty" at all, (2) supposing it can be so regarded, whether no "penalties" are deductible as "ordinary and necessary expenses" of a business under § 23(a) (1) (A); and (3) if some penalties are, and some are not, deductible, whether this "penalty" is among those which may be deducted. First, it seems apparent to us that the payment of the overcharge — which is all that is here involved — can on no theory be treated as the payment of a "penalty." Taken in its broadest sense that word has a punitive, as opposed to a remedial, meaning; it covers fines and other exactions

which are not restitution for a wrong, and are only justified, either as a deterrent, or in order to satisfy an atavistic craving for retaliation. A seller's duty to return the overcharge to the "terminal buyer" that is, to one "who buys . . . for use, or consumption other than in the course of trade or business," is so clearly not a "penalty" under this definition that no argument can make it plainer than its bare statement. The only possible excuse for confusion is that § 205(e) gave to the "terminal buyer" a claim, not only to recover the overcharge, but twice its amount in addition; and we will assume that the addition was a "penalty" (though even that is not absolutely certain). However, a recovery of three times the overcharge is no less a recovery of the overcharge because it includes the penalty along with it. Hence, if the taxpayer had been able to distribute the overcharge to the "terminal buyers," and had done so, the distribution would have been deductible. It did not make such a distribution because it could not; but in its stead it paid the overcharge to the Administrator upon his agreeing not to press for more. We agree with the Commissioner that this was not a voluntary payment, or a gratuity, § 205(e) imposed upon the taxpayer a duty to the Administrator in precisely the same terms as its duty to the "terminal buyer"; and, although that duty was conditional upon the "terminal buyer's" being "not entitled to bring suit," we will assume that in the case at bar that condition was fulfilled. However, the Administrator's claim, like the "terminal buyer's" claim for which it is a substitute, is also made up of the overcharge and an addition of twice its amount; and the Commissioner must maintain that the part of it, which is made up of the overcharge, is a "penalty" and loses its character as restitution even though the Administrator demands only the overcharges. There is no basis for such a conclusion. The taxpayer wished to abandon the overcharge; it recognized that the fund belonged to the "terminal buyers"; and, since the "terminal buyer" was inaccessible, the overcharge "was subject . . . to the right of appropriation by the sovereign as bona vacantia," even though, strictly speaking, it may not have been "the subject of escheat." Indeed, if § 205(e) had not intervened, conceivably as matter of strict theory, the overcharge might have passed to the several states.

Assuming, however, that we are wrong, and that the payment can be regarded as that of a penalty, the second question is whether in no circumstances could it be an "ordinary and necessary expense" of the business. The Revenue Act does not declare that penalties may not be deducted; the doctrine is a judicial gloss — and, for that matter, a gloss of the lower courts only, save as the Supreme Court recognized it by implication in *Commissioner* v. *Heininger*.[1] We agree that it is a proper gloss (indeed we have ourselves enforced it several times); [2] and its justification is that, when acts are condemned by law and their commission is made punishable by fines or forfeitures, to allow these to be deducted from the wrongdoer's gross income, reduces, and so in part defeats, the prescribed punishment. Obviously, to relieve the wrongdoer of a part of the tax due upon his income, in effect is to remit that much of the sanction imposed; as would at once be apparent, if we were to compare the case of a wrongdoer who has an income with that of one who has none. Hence, if one rigorously applied the doctrine, a taxpayer could never deduct the payment of fines and forfeitures; and we can

1 320 U.S. 467, 64 S. Ct. 249, 88 L. Ed. 171.

2 Burroughs Building Material Co. v. Com'r, 2 Cir., 47 F.2d 178; Gould Paper Co. v. Com'r. 2 Cir., 72 F.2d 698; National Outdoor Advertising Bureau v. Helvering, 2 Cir., 89 F.2d 878.

see no relevant distinction between them and legal expenses incurred in an unsuccessful effort to prevent their collection. Indeed, to hold otherwise would be to subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offence; and for this reason in the decisions just cited we held that such legal expenses were never deductible. The Supreme Court overruled this doctrine in *Commissioner* v. *Heinninger, supra;* and the question is as to the scope of that decision. It is possible to read it as distinguishing between the legal expenses of an unsuccessful defence and the payment of fines or forfeitures. On the other hand, it is also possible to read it as meaning that, whether the claimed deduction be of legal expenses or of fines or forfeitures, its allowance depends upon the place of sanctions in the scheme of enforcement of the underlying act. We think that the second is the right reading; in short that there are "penalties" and "penalties," and that some are deductible and some are not. This we infer, not only because the result of denying deductibility only to legal expenses would, as we have said, put a premium upon resistance, but because of the following language, which was the kernel of the ratio decidendi: "If the respondent's litigation expenses are to be denied deduction, it must be because the allowance of the deduction would frustrate the sharply defined policies . . . which authorize the Postmaster General to issue fraud orders." 320 U.S. at page 474, 64 S. Ct. at page 254, 88 L. Ed. 171. Again: "We hold therefore that the Board of Tax Appeals was not required to regard the administrative finding of guilt . . . as a rigid criterion of the deductibility of the respondent's litigation expenses." 320 U.S. at p. 475, 64 S. Ct. at page 254, 88 L. Ed. 171. Perhaps the deduction of a fine or forfeiture after an "administrative finding of guilt," is more likely to "frustrate" the "sharply defined policies" of a statute which imposes it, than the deduction of the legal expenses of an unsuccessful defence — though that seems questionable — but certainly there is no more ground for taking as "a rigid criterion" the imposition of the fine than the incurrence of the expenses. Each may "frustrate the sharply defined policies" of a statute; that will depend upon how one views their deterrent effect. We hold therefore that in every case the question must be decided ad hoc.

This conclusion leads directly to the third question: whether, even though the overcharge was a "penalty," its allowance as a deduction would "frustrate" any "sharply defined policies" of the Emergency Price Control Act of 1942. It is impossible to find an answer in general terms; indeed any answer goes to the very root of one's theory of criminal law. Happily, in the case at bar, we are not left to speculation, for we have an answer from the best possible source — the Administrator himself. The body of regulations, by which the United States sought to control prices during the last war, was extraordinarily complicated and difficult to comprehend. That was inevitable; the innumerable varieties of commercial transactions to be covered made possible nothing simpler. One may indeed argue, as the Commissioner does, that the more unsparing and relentless was the pursuit of offenders, however innocent they may have been of any wilful violation of the regulations, the more solicitous would they become to comply, and the more effective would be the enforcement of the Act. That has been a school of penology since the time of Draco; but it has not been the only school, and, as we read *Commissioner* v. *Heininger, supra,* the Supreme Court did not accept it. The Administrator did not believe that such a rigid and uncomprising policy was the

best way to realize the purposes of the Act. When the amendment to § 205(e) was being considered in 1944, he declared in a letter to the Senate Committee "that the protection of innocent violators from excessive damages" was "obviously desirable"; and that it had been his "policy to adjust cases involving innocent violations by payment of merely the amount of the overcharge." He thought that Congress had given him discretion not to sue for "treble damages" in some instances, and he had exercised that discretion so as "to avoid undue hardship in deserving cases." In short, he did not believe that it paid to sweep into the same pool with wilful or careless violators, violators for whom the daedalian mazes of the regulations had proved too much. Moreover Congress showed in 1944 by the amendment of § 205(e) that it agreed with the Administrator. It seems to us that we should accept these expressions as evidence that in cases where the Administrator accepted the overcharge as sufficient, it did not "frustrate" any "sharply defined" policies of the Emergency Price Control Act of 1942.

Hence, we hold erroneous the order assessing the deficiency. First, we say that on no theory was the payment of the overcharge to the United States the payment of a "penalty." Second, we say that, even if it was the payment of a "penalty," that is not a "rigid criterion" of its deductibility. Third, we say that there was positive and compelling evidence that to allow such a deduction would not "frustrate" the policies of the underlying act. It is true that although the order were reversed, it would not inevitably follow that the deficiency should be expunged. The practice of the Administrator was to accept the overcharge as adequate compliance only if the seller had both acted in good faith, and had taken all "practicable precautions"; and the Tax Court found, as we said at the outset, that it was not "too clear" that in this case the taxpayer "might not have avoided" the overcharges by "more appropriate accounting." So it may be argued that the taxpayer did not carry the burden of proof of showing that the deduction would not "frustrate" the Act. It is true that this would be irrelevant to the first point; for, if the payment was only restitutionary, it could not be a penalty in any event. On the other hand, lack of proper care would be relevant to the third point: whether the allowance would "frustrate" the Act. However the Administrator's consent to accept the overcharge showed that he thought that the taxpayer had in fact used adequate care; and that was enough. We do not say that his decision was final; but it stands uncontradicted, and it was the judgment of one who was in the best possible position to make an estimate.

The deficiency determination also included adjustments not here in controversy. The order of the Tax Court is reversed; the deficiency is expunged so far as it results from disallowance of the deduction of the payment to the United States, and the cause is remanded to the Tax Court for recomputation of the taxes involved in conformity with the opinion of this court.

Note

1. See also *Commissioner* v. *Pacific Mills*, 207 F.2d 177 (1st Cir. 1953). Would public policy have been frustrated if the taxpayer had deducted the payment in a year when his marginal tax rate was higher than it was in the year of sale? If the buyer had sued for and recovered the overpayment, tripled, could the seller have deducted the entire amount? On the *Rossman* case, see Note, 59 *Yale L.J.* 561 (1950).

2. Would public policy be frustrated if the taxpayer were allowed to deduct a

fine—for example, those imposed on a taxicab or trucking company for minor traffic violations? What about commercial bribery, *i.e.*, payments to purchasing agents? Commissions to "influence peddlers?" Payments to corrupt union officers? The expense of entertaining public officials? See generally Lurie, "Deductibility of 'Illegal' Expenses," *11th Annual N.Y.U. Inst. on Fed. Taxation* 1189 (1953).

3. Lobbying expenses have been held non-deductible largely because of a long-standing administrative ruling now found in Regs. 118, Sec. 39.23(q)-1. *Textile Mills Securities Corp.* v. *Commissioner*, 314 U.S. 326 (1941); see also *American Hardware & Equipment Co.* v. *Commissioner*, 202 F.2d 126 (4th Cir. 1953). Should such expenses be deductible if related to the taxpayer's trade or business? As already noted, *supra*, p. 191, uncollectible loans to political organizations may not be deducted as bad debts. Campaign expenses of the candidate himself (an unsuccessful one) were disallowed, by a divided court, in *McDonald* v. *Commissioner*, 323 U.S. 57 (1944), and a successful candidate got the same treatment in *Mays* v. *Bowers*, 201 F.2d 401 (4th Cir. 1953), where the court also refused to allow the expenses to be amortized over the officer's term. The court expressed the view that *allowing* a deduction would subsidize wealthy candidates, while the dissenting Justices in the *McDonald* case felt that *denying* the deduction would favor the "independently wealthy." In 1952 the Treasury announced its view that a Congressman might deduct the cost of printing and mailing a report on his official activities together with a "brief personal message" to his constituents·

> It is often difficult to determine the line of demarcation between deductible business expenses and non-deductible campaign expenses of a Congressman. The mere fact, however, that it might be politically expedient for a Congressman to incur an otherwise deductible expense would not ordinarily convert that expense into a non-deductible campaign expense. (I.T 4095, 52-2 C.B. 90.)

See Note, 67 *Harv. L. Rev.* 1408 (1954).

4. What about legal expenses? If the taxpayer is convicted of a criminal offense, the legal expense is not "ordinary and necessary." *Thomas* v. *Commissioner*, 16 T.C. 1417 (1951); *Bloom* v. *Commissioner*, ¶ 48,138 P-H Memo TC (1948). Legal expenses incurred in civil proceedings, however, have been allowed as deductions even though fraud or similar conduct was charged and regardless of the outcome. *Commissioner* v. *Heininger*, 320 U S. 467 (1943) (mail fraud; taxpayer lost in proceeding to regain right to use mails), *Longhorn Portland Cement Co.* v. *Commissioner*, 3 T.C. 310 (1944) (state anti-trust proceedings, taxpayers consented to entry of judgment against them without admitting violation); *Greene Motor Co.* v *Commissioner*, 5 T.C. 314 (1945) (compromise of civil tax fraud case). See, however, *Stralla* v. *Commissioner*, 9 T.C. 801 (1947), disallowing legal expenses incurred in civil proceedings and in the successful defense of criminal proceedings because the enterprise itself (gambling ship operated off California coast) was illegal. Does Judge L Hand's opinion indicate that the "frustration of public policy" approach of the *Rossman* case will be applied to legal expenses? If the deduction claimed in that case had been denied (on a finding that the violation of the price regulation was avoidable or deliberate), would the taxpayer also have been denied the right to deduct the legal fees he incurred in the controversy with the Price Administrator? The legal fees incurred in the tax case itself? See generally Moser, "Deductibility of Legal and Tax Advice Fees," *11th Annual N.Y.U. Inst. on Fed. Taxation* 1217 (1953); Magill, "The Income Tax Aspects of Antitrust Litigation," 30 *Taxes* 210 (1952).

2. *Bad Debts*

Note: **Section 2(k)(1) of the 1939 Code, setting out the general rule for the deduction of bad debts, is rewritten, but without substantive change, by §§ 166(a) and 166(c) of the 1954 Code.**

Section 166(b) of the 1954 Code, relating to the basis for determining the amount of the deduction, is carried over without substantive change from § 23(i) of the 1939 Code.

Section 23(k)(4) of the 1939 Code, relating to "nonbusiness debts," is carried over, somewhat modified, by §§ 166(d) and (e) of the 1954 Code.

Sections 23(k)(2), 23(k)(3), and 23(k)(5), relating to worthless securities, have been consolidated with § 23(g)(2)-(4), relating to worthless stock, and with minor changes these sections appear as § 165(g) of the 1954 Code.

Section 166(f) of the 1954 Code, relating to guarantors of certain obligations, is new.

See Regs. 118, Sec. 39.23(k).

It has already been seen that bad debts are deductible, whether incurred in business or not. *Supra*, p. 189. Some problems connected with bad debts (*e.g.*, ascertaining the year of worthlessness) are common to business and non-business bad debts. Similarly, whether the taxpayer is engaged in business or not, he may not (if he is on the cash basis) deduct an uncollectible claim for unpaid salary, for goods sold on credit, *etc.*, since the claim has not been taken into income. (This restriction would not apply to a claim which, if collected, would not constitute income to the taxpayer, *e.g.*, a bad debt arising from a loan of his capital.) An accrual basis taxpayer, however, may deduct (or set up a reserve to provide for) bad debts under these circumstances, since the items were reported as income when accrued. See Regs. 118, Sec. 23(k)-2.

There are other problems, however, that are not common to both types of debts. Thus, the use of a reserve for bad debts, instead of a direct deduction of them, is common business practice; a reserve, though not forbidden to non-business taxpayers, would rarely if ever be employed by them. This method of providing for bad debts starts with an estimate each year of the amount of accounts then on the taxpayer's books that will prove to be uncollectible. In making this estimate, the taxpayer may "age" his accounts receivable, *i.e.*, classify them according to the due date, taking a larger percentage of those that are seriously delinquent than of those that are only slightly in arrears. If his existing reserve (built up by deductions in previous years and reduced by debts that have actually proved uncollectible) is insufficient to provide for the estimate, the taxpayer adds an amount to the reserve to build it up to the estimate. The amount thus added to the reserve is deducted in the taxable year. See *Mill Factors Corp.* v. *Commissioner*, 14 T.C. 1366 (1950).

It will be noted that unduly pessimistic estimates of bad debts made in earlier years are corrected by reducing the additions to the reserve in later years. Thus, if on December 31, 1952 the taxpayer had $100,000 in accounts receivable outstanding, against which a reserve of $5,000 had been provided, and if $2,000 of these accounts proved uncollectible during the year 1953, his bad debt reserve will have a balance of $3,000 at the end of 1953. If at that time he has $90,000 of accounts, of which $4,000 can be expected to prove uncollectible, the addition to the reserve in 1953 need be only $1,000 to give full protection against the anticipated losses. Conversely, an unduly optimistic estimate in an earlier year will be corrected by making a larger addition to the reserve in a later year.

It has already been noted that "non-business bad debts" are treated as capital losses (*supra*, p. 191), which means that their deductibility is limited. There has been a substantial volume of litigation on the issue of categorizing bad debts for this purpose, of which the following case is an illustration.

COMMISSIONER v. SMITH

U. S. Court of Appeals, Second Circuit, 1953
203 F.2d 310

Before SWAN, Chief Judge, and CHASE and CLARK, Circuit Judges.

CLARK, Circuit Judge.

In this case the taxpayer Weldon D. Smith sought restoration of a deduction of $38,220 in his income tax return for 1945 which the Commissioner had disallowed. The taxpayer claimed this deduction as a business debt which became worthless during the year as authorized by I.R.C. § 23(k)(1). The Commissioner challenged the deduction on several grounds. A majority of the Tax Court sustained the taxpayer's claim in an opinion by Judge Rice, 17 T.C. 135. Six of the judges dissented, however, Judge Disney writing a dissenting opinion in which four of his colleagues concurred. The Commissioner now petitions for review, contending that the amount in question is a non-business debt and hence is only a loss of a capital asset within the more limited deductibility of I.R.C. § 23(k)(4). The sole question therefore is whether this worthless debt arose from a trade or business in which the taxpayer was engaged.

A summary of the pertinent findings of fact by the Tax Court will suffice here. Respondent, a resident of Buffalo, N. Y., became interested in 1936 in Llenroc Farm, located on the Canadian side of the Niagara River and then operated as a dairy farm and for the raising of prize cattle by the Houck family—a mother and three sons. The Houcks sought someone to assume business management of the farm; and accordingly respondent joined them in January, 1937, in forming a Canadian corporation—Llenroc Farms, Ltd.—of which respondent became treasurer and general manager in addition to being a 20 per cent stockholder. In his managerial capacity, respondent supervised such matters as personnel, purchasing, seeding plans, and crop gathering, attending to these activities in the evenings and on Saturdays and Sundays. Since the new corporation displayed a persistent, if disheartening, propensity to sustain operating losses, respondent extended to it numerous loans which, by 1945, totalled $38,220. In that year the corporation filed a general assignment of its assets for the benefit of creditors, rendering worthless the debt respondent now seeks to deduct.

Aside from this agrarian venture, respondent was interested at one time or another in numerous other business enterprises and had investigated possibilities of investing in many more. Until January 1, 1945, his regular work day was apparently spent at the offices of Adam, Meldrum & Anderson Co., a Buffalo department store, of which he had been general manager for the preceding ten years, as well as a substantial stockholder. He had also lent money to this company by leaving some of his earnings with it, collecting 6 per cent interest thereon. Another enterprise in which respondent was interested was Adam, Meldrum & Anderson

Cleaning Corp. (not connected with the department store) in which he held 49 per cent of the stock and served as an officer and director until the business was sold in 1944 or 1945, here, too, he left some of the salary credited to him with the corporation. In addition, respondent was a stockholder and director of Adam, Meldrum & Anderson State Bank and of Central Cleaning Plant, both of which merely involved attending board meetings. His other business ventures consisted of a partnership with his brother operating a garage in whose management he participated and to which he lent money, ownership and management of a business building in Buffalo; and, subsequent to 1945, serving as president and manager of the Oliver Gear Work, of which he was a 99 per cent stockholder and where he also left part of his salary to collect interest. Neither the Tax Court's findings nor the evidence upon which they rest indicate explicitly the extent to which these businesses occupied respondent's time and attention during 1945. The majority of the Tax Court found, however, that "Petitioner [respondent here] was in the business of giving financial aid and personal services to business ventures and, therefore, the $38,220 represented a bad debt which arose from a business regularly engaged in by petitioner which became worthless in 1945."

Whether a particular loss or expense is incurred in a taxpayer's trade or business is a question of fact in each particular case. *Higgins* v. *C. I. R.*, 312 U. S. 212, 61 S. Ct. 475, 85 L. Ed. 783, Treas. Reg. 118, § 39.23(k)-6. But insofar as this determination involves interpretation of the statutory language, it raises an issue of law on which the Tax Court's decision is subject to review here. *Washburn* v. *C. I. R.*, 8 Cir., 51 F.2d 949, 951. In the instant case we think the court below employed an erroneous view of the applicable Code provisions—§§ 23(k)(1) and 23(k)(4)—in arriving at its ultimate finding that respondent's bad debt loss was incurred in his trade or business.

Although Congress has never defined the term "trade or business," it is clear that this concept as used in § 23(k) does not encompass all activities engaged in for profit. The nature and congressional history of the more restricted meaning of "trade or business" is carefully analyzed by Judge Disney in his able dissent in the Tax Court and we need only allude to it briefly here. When in 1942 Congress amended § 23(k) to provide for different treatment of nonbusiness bad debts from that accorded such losses when incurred in a trade or business, the committee reports in both houses stated that the determination whether a debt is incurred in a trade or business "is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is 'incurred in trade or business' under paragraph (1) of that section." 1942-2 Cum. Bull. 573. Section 23(e), dealing in general with losses sustained by individuals, explicitly establishes a distinction between losses incurred in trade or business and those stemming from "any transaction entered into for profit, though not connected with the trade or business." With this guide to the interpretation of § 23(k), it becomes apparent that Congress did not adopt the broad definition of "business" in *Flint* v. *Stone Tracy Co.*, 220 U.S. 107, 171, 31 S. Ct. 342, 357, 55 L. Ed. 389, on which respondent relies. The Court there said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed. Black's Law Dict. 158, citing *People ex rel. Hoyt* v. *Tax Com'rs*, 23 N.Y. 242, 244. 'That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.' 1 Bouv. Law Dict. [Rawles Third Revision]

p. 273." The *Flint* definition was subsequently rejected by the Supreme Court in interpreting the term "trade or business" as used in I.R.C. § 23(a) providing for deduction of ordinary and necessary expenses incurred in carrying on a trade or business. *Higgins* v. *C. I. R.*, *supra*. We deem the definition equally inapplicable here.

The cases interpreting the statutory phrase in particular situations of course do not chart its precise limits, but they do lead us to the conclusion that in the present case respondent's bad debt loss was not incurred in any trade or business. The full-time management of one's investments does not constitute a trade or business. *Higgins* v. *C. I. R.*, *supra*. Nor does serving as an officer of a corporation of which the taxpayer is a stockholder and creditor. *Van Dyke* v. *C. I. R.*, 23 B.T.A. 946, affirmed per curiam, 9 Cir., 63 F.2d 1020, affirmed per curiam, *Van Dyke* v. *Helvering*, 291 U.S. 642, 54 S. Ct. 437, 78 L. Ed. 1040, see *McGinn* v. *C. I. R.*, 9 Cir., 76 F.2d 680, 681, 99 A.L.R. 564 Affirmance of the *Van Dyke* case in both the court of appeals and the Supreme Court was based on the authority of *Burnet* v. *Clark*, 287 U.S. 410, 53 S. Ct. 207, 77 L. Ed. 397, and *Dalton* v. *Bowers*, 287 U.S. 404, 53 S. Ct. 205, 77 L. Ed. 389. The *Clark* case held that an officer and majority stockholder of a corporation could not treat the loss sustained by endorsing the corporation's notes to protect his investment as incurred in a trade or business. Respondent's activities in the case at bar were essentially similar to those of the taxpayer in the *Clark* case, except that respondent here was interested as an investor, manager, and creditor in a number of business enterprises. But since each of these activities separately does not constitute a business, we cannot see how a combination of them spread over various businesses can alter the result. Of course, if respondent were regularly engaged in lending money to business enterprises, bad debt losses resulting therefrom would be incurred in his business. But respondent himself testified that he was never in the money lending business, and the other evidence in the record supports this conclusion.

Accordingly, the decision of the Tax Court is reversed for recomputation of the tax in accordance with this opinion.

Note

1. Would the taxpayer's tax status have been better if, instead of lending on open account, he had taken the corporation's bonds as evidence of the indebtedness? Examine § 166(e) and § 165(g). How would the taxpayer's losses have been treated if the farm had been operated as a partnership, and the taxpayer had advanced funds to pay its expenses, his partners agreeing that these advances would be paid off before any distribution of profits or of capital?

Compare the court's statement in the last paragraph about corporate officers with the *Hochschild* case, *supra*, p. 225.

2. Another consequence of treating a debt as a "non-business" one is that it cannot be deducted until entirely worthless; only business debts qualify under § 166(a)(2)'s provision that "when satisfied a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." Regs. 118, Sec. 23(k)-6(a).

3. Note the definition of "non-business debt" in § 166(d)(2). Before 1954, the statute included clause (B) of this definition, but clause (A) is new in the 1954 Code. It overrules the position taken in Regs 118, Sec. 39.23(k)-6(c), Example (2), that even though a claim arose in connection with the taxpayer's trade or business, it is a non-business debt if he is no longer engaged in a trade or business when it becomes worthless.

4. See generally Justis, "Is It a Debt? Is It a Bad Debt? Is It a Business Bad Debt?" *10th Annual N.Y.U. Inst. on Fed. Taxation* 183 (1952); Friedman, "Bad Debts: Business or Non-Business?" *5 Tax L. Rev.* 412 (1950).

FOX v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1951
190 F.2d 101

Before SWAN, AUGUSTUS N. HAND, and CLARK, Circuit Judges.

CLARK, Circuit Judge.

Agnes I. Fox, the taxpayer and petitioner for review, in 1935 entered into a written guaranty of certain debts of her husband and now seeks to deduct as a loss from her 1944 income the sum of $15,000 paid by her on the guaranty in that year. The Tax Court treated the payment as a "non-business" bad debt, subject to deduction only to the extent of a short-term capital loss, *viz.*, $1,156.25. 14 T.C. 1160 (one judge dissenting). We agree with the taxpayer, however, that she has brought herself within the statutory definition of a loss from a "transaction entered into for profit" and hence is entitled to the deduction in full.

The statute upon which petitioner relies is I.R.C. § 23(e), which permits an individual taxpayer to deduct

> losses sustained during the taxable year and not compensated for by insurance or otherwise—
> (1) if incurred in trade or business; or
> (2) if incurred in any transaction entered into for profit, though not connected with the trade or business.

In assessing the deficiency the Tax Court relied on a new provision effective with the 1934 tax — see Act Oct. 21, 1942, § 124(a) — entitled "Non-business debts" and providing, in the case of a non-corporate taxpayer, that "if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months." It also provided that the term "non-business debt" meant one "other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." I.R.C. § 23(k)(4). The respondent Commissioner originally relied on this statute, but appears later to have taken and held the position that the transaction was a gratuity, preventing the allowance of any deduction at all.

The facts were stipulated and disclosed the following: Prior to December, 1932, petitioner owned some securities which she lent to her husband, William J. Fox. Fox was trading on the New York Stock Exchange through his brokers, Hilson & Neuberger, and prior to December 31, 1932, he had deposited these securities with the firm as collateral for his indebtedness to them on open account. On that day the Hilson firm liquidated and went out of business. Earlier in the month Fox had been told that this was going to happen and that the accounts of the Hilson firm would be taken over by another, Wertheim & Company, but that Wertheim would not assume his account without more collateral. Thereupon Fox tried to get petitioner to lend him more securities. She refused. But Fox pointed out that she would lose what she had already invested if she did not protect it.

So she executed a guaranty to Wertheim on December 16, 1932. This, in the language of the Tax Court,

> recited that in consideration of that company opening, or continuing, an account or accounts with or otherwise giving credit to Fox on such terms as that company might deem best, the petitioner unconditionally promised to pay the company on demand any debit balance or balances, and all losses, then, or which might thereafter, be owing to the company by reason of said account or accounts. The instrument further provided that the guaranty therein was a continuing one and should cover the period of existence of said account or accounts, and that said account or accounts might be changed from time to time by the purchase or sale of securities or other property or by payments or deliveries of securities or other property to Fox without notice to the petitioner.

At this time Fox owed his brokers $91,043.52; and the value of all securities in the account was only $71,633, of which $33,263 represented the value of those supplied by petitioner. So the Tax Court found that

> the petitioner executed the guaranty because she did not want to lend any more securities to Fox and because she thought she would protect the securities she had theretofore loaned him.

In 1935, Fox transferred his brokerage account to another firm, Engel & Company, "for the purpose of saving interest"; and on August 16, 1935, petitioner executed to this firm another instrument of guaranty similar in its terms to the one previously given Wertheim. When the transfer to Engel was made, Fox's debit balance was $152,357.04. On October 19, 1937, Fox died, being then indebted to his brokers in the sum of $155,478.17. The sale of the securities pledged in the account brought in $14,212.03, thus reducing the indebtedness to Engel to $141,266.14. But Fox's estate was insolvent and his executors were discharged by the surrogate's court on July 31, 1940. Petitioner has therefore been forced to make payments to Engel and its successors yearly since 1937 — usually in the sum of $15,000 — which have totaled some $121,269.50. Only the payment of $15,000 in 1944 is here in issue.

For most of the payments made by petitioner this question could not be raised. Not until Congress changed the statute to make a deduction labeled a worthless "non-business debt" so much less advantageous to the taxpayer than one labeled a "loss" in a non-business transaction "for profit" did the need for making this narrow line of demarcation become insistent. True, it had been ruled that the categories were mutually exclusive; what was a bad debt could not be a loss and vice versa. *Spring City Foundry Co.* v. *C. I. R.*, 292 U.S. 182, 54 S. Ct. 644, 78 L. Ed. 1200. When petitioner filed her 1944 return, she reported the $15,000 payment as a "miscellaneous" deduction, describing it as "Payment on guaranty —Wm. J Fox brokerage a/c." At the hearing she claimed the deduction as a loss in a transaction entered into for profit, but was met with the contention that it was only a bad debt because on payment she would have a claim for reimbursement against her guarantor. Although this is the basis upon which a majority of the Tax Court found against her, she has steadily objected to it for its illusory character, since at the time of her payment her husband had been dead and his insolvent estate closed for several years. She argues that the court's theory of a debt against her husband's estate amounts to a subrogation forced upon her, con-

trary to the equitable spirit of the doctrine, to yield her an utterly worthless claim and a very real tax liability.

Although no authorities seem directly decisive, we think her argument persuasive. Of course we may say, as does respondent, that the taxpayer claiming the benefit of a deduction has the burden of proving it; but that does not mean that a statute limiting a deduction must be given a broad meaning beyond its terms. Here petitioner may have been acting gratuitously when she originally allowed her husband to pledge her securities. But we need not go back that far, for when in 1932 she refused further pledge and then reluctantly signed the guaranty (renewed in 1935) she was in fact securing the release of her securities. Whether she was well or ill advised in so doing, her act, on the Tax Court's finding as to her purpose, was a transaction entered into with the hope of profit or perhaps more specifically of cutting her losses. *Cf. Weir* v. *C. I. R.*, 3 Cir., 109 F.2d 996, 997, certiorari denied 310 U.S. 637, 60 S. Ct. 1080, 84 L. Ed. 1406. Moreover, her then present intent would control, whatever had been her earlier purpose. *Heiner* v. *Tindle*, 276 U.S. 582, 48 S. Ct. 326, 72 L. Ed. 714; *Evans* v. *Rothensies*, 3 Cir., 114 F.2d 958, 962. Clearly, too, the transaction was not then one involving a bad debt, since she had not even made the payment which alone would give rise to a claim in her favor. Nor could payment ten years later create a debt out of something less than even the proverbial stone. It is utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection. Actually it was merely the fulfillment of her contractual obligation of the earlier date. The bad-debt provision thus had no direct application; only by straining the statutory language can we erect here a disembodied debt against an insolvent and long dead debtor. . . .

We agree further with the dissenting judge below, who held that the payment cannot be translated into a debt which "compensated" for the payment within the meaning of I.R.C. § 23(e) where recourse to the original debtor's estate was now obviously out of the question. This conclusion actually accords with that reached by the Tax Court in cases involving debtors who have gone out of existence or been reorganized so that a claim may no longer be enforced against them. *Abraham Greenspon*, 8 T.C. 431; *Frank B. Ingersoll*, 7 T.C. 34. And it does no violence to the theory that a debt might arise upon payment by a guarantor where the principal debtor remains still in existence. *D. W. Pierce*, 41 B.T.A. 1261; *Daniel Gimbel*, 36 B.T A. 539. Deduction of the payment should therefore have been allowed in full.

The decision of the Tax Court is accordingly reversed.

Note

1. In *Pollak* v. *Commissioner*, 209 F.2d 57 (3d Cir. 1953), the taxpayer paid under a guaranty the debts of a corporation that was insolvent when he paid. The Commissioner argued that the *Fox* case was not in point because there the principal debtor had died, his estate was insolvent, and his executor had been discharged, while in the *Pollak* case the corporation was still in existence. The court said:

> We see no legal significance in this difference, however. For in each case the payments were made in fulfillment of a pre-existing legal obligation and not because of any present expectation of repayment by the principal debtor. And in each case the debt arising under the doctrine of subrogation was substantially uncollectible

from the time it arose. Moreover, for this very reason the loss was not "compensated for" within the meaning of Section 23(e) of the Internal Revenue Code, by the acquisition of an equivalent asset, a collectible debt. And by the same token the loss could not be a debt which, within the meaning of Section 23(k)(4), "becomes worthless within the taxable year." For the debt, if we call it such, was worthless when acquired, and, therefore, did not and could not become worthless at any time thereafter.

See also *Allen* v. *Edwards*, 114 F. Supp. 672 (M.D Ga. 1953). Would the taxpayer in *Commissioner* v. *Smith, supra*, p. 257, have been better off if he had guaranteed the corporation's obligations instead of advancing funds to it?

2 See § 166(f), which is new in the 1954 Code. What is it intended to do? The Senate Report (p. 200) states

> If the requirements of this section are not met, the taxpayer will, as under present law, be treated taxwise under whatever provisions of the code are applicable in the factual situation. However, if the requirements are met, he will obtain a deduction from ordinary income and the nonbusiness bad-debt rules of subsection (d) [of Section 166] (treating the loss as a short-term capital loss) will not be applicable.

3. *Depreciation and Obsolescence*

> ***Note*· Section 167 of the 1954 Code, relating to depreciation, is derived from § 23(1) of the 1939 Code, but with substantial modifications.**

BULLETIN "F"

Bureau of Internal Revenue, 1942, pp 1–5

DEPRECIATION — OBSOLESCENCE — DEFINITIONS

The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.

It is elemental that in determining the net income derived from the operation of a trade or business, all operating costs and expenses allowable as deductions must be determined and deducted from the gross income. The consumption of trade or business capital represented by depreciation is an operating cost the deduction of which in computing net income is specifically provided for in the Internal Revenue Code and several prior Revenue Acts, as follows

> *Depreciation.* A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

The factors of wear and tear and decay cause physical exhaustion, or deterioration, ultimately resulting in retirement of the property, while those retirements due to obsolescence are caused by forces ordinarily unrelated to physical condition.

Obsolescence may be defined as the process of becoming obsolete due to progress of the arts and sciences, changed economic conditions, legislation, or

otherwise, which ultimately results in the retirement or other disposition of property. As said by the Supreme Court in *United States Cartridge Co.* v. *United States* (1932) (284 U.S. 511, 516, Ct. D. 460, C.B. XI-1, 282, 283 (1932),

> Obsolescence may arise from changes in the art, shifting of business centers, loss of trade, inadequacy, supercession, prohibitory laws and other things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value.

With respect to any property for which past experience indicates a gradual lessening of useful value due to inadequacy or obsolescence and when the effects of such factors can be expected to continue without substantial variation, the annual diminution in useful value is considered ordinary or normal obsolescence to be included in depreciation. Much of the discussion hereinafter having specific reference to depreciation only is in fact equally applicable to normal obsolescence.

Some property, however, may become obsolete or inadequate due to revolutionary or radical changes unforeseen and unpredictable by their nature when the property was acquired. To distinguish from the allowance for what is considered normal obsolescence, this type is usually termed extraordinary or special obsolescence, allowances for which will be dealt with more specifically hereinafter. . . .

Allowance for Depreciation and Obsolescence

The proper allowance for exhaustion, wear and tear, including obsolescence, of property used in trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property. In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost or other allowable basis and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business.

The allowance in any given year must be determined in accordance with the conditions existing at the end of the year, and a taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation deduction or of his action in taking deductions plainly inadequate under the known facts in prior years.

Probable Useful Life — Rate of Depreciation and Obsolescence

In general. The amount of the annual deduction allowable for depreciation is ordinarily dependent upon the expected useful life of the asset. The factors which determine the useful life of property in a trade or business have already been discussed briefly in the Introduction. These factors are wear and tear and decay or decline from natural causes; and also various forms of obsolescence attributable to the normal progress of the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business. Two principal forms or types of obsolescence are generally recognized, that is, normal obsolescence and extraordinary or special obsolescence.

Normal obsolescence is caused by factors which can be anticipated with substantially the same degree of accuracy as other ordinary depreciation factors, such as wear and tear, corrosion or decay. Accordingly, it is included in estimating the normal useful life of depreciable property, the effect of which is to include the allowance for normal obsolescence in the depreciation deduction.

Extraordinary or special obsolescence rarely can be predicted prior to its occurrence. However, this does not necessarily imply that the asset already must have been completely discarded or become useless, but merely that a point has been reached where it can be definitely predicted that its use for its present purpose will be discontinued at a certain future date. Deductions for obsolescence of this type may be taken over the period beginning with the time such obsolescence is apparent and ending with the time the property will become obsolete. In every case the burden of proof is entirely upon the taxpayer to establish a claim for obsolescence by facts and evidence that are definite and indisputable. No amount may be charged off in any year merely because, in the opinion of the taxpayer, property may become obsolete a number of years later. The allowance will be confined to such items or such portion of the property on which obsolescence is definitely shown to be sustained, and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which the obsolescence is found to be due. Nor can obsolescence be allowed retrospectively in the light of subsequent events or happenings not anticipated during the period for which the obsolescence is claimed. In no case may the deduction for obsolescence be extended to include shrinkage in value due to other causes, as, for instance, a general drop in the price of commodities.

Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry and the particular trade or business, furnish a reliable guide for the determination of the useful life of the property. Such a determination should reflect all the peculiar circumstances of the use or operation of the property, such as the purpose for which it is utilized, the conditions under which it is used or operated, the policy as to repairs, renewals, and improvements, and the climatic and other local conditions.

Unusual conditions; abnormal depreciation. It is recognized that the useful life of some depreciable property, or items thereof, may be affected by a radical increase or decrease in plant activity, or diversion in use, extending over a period of time so that depreciation in excess of, or less than, the amounts allowable under normal operating conditions or use may be sustained. Such increase or decrease in depreciation is dependent upon the decrease or increase, respectively, in the normal useful life resulting from the exceptional operating conditions or use. However, where factors of obsolescence and inadequacy and decay control the useful life of property, no increase or decrease from normal depreciation will be allowed. Any modification of normal depreciation, therefore, must be confined to those items the useful lives of which are controlled by the factor of use or wear and tear. Moreover, since accelerated use of property is almost invariably accompanied by an increase in maintenance and repair charges, accelerated depreciation is allowable only to the extent that such maintenance and repair fail to arrest acceleration or depreciation.

Methods of Apportionment

The capital sum to be replaced by allowances for depreciation over the useful life of the property may either be deducted in equal annual installments or in accordance with any other recognized trade practice, such as apportionment to units of production. While no specific method is prescribed, whatever plan or method of apportionment is adopted must be reasonable and cannot be changed in a later year without the consent of the Commissioner. The methods in general use by taxpayers are the "straight-line" and the "unit of production," the latter being used for the most part by taxpayers owning natural resource property. These, with other methods used to a lesser extent, are described below.

Straight-Line Method

Under this method, the cost or other basis of the property, less its estimated salvage value, is deducted in equal annual installments over the period of its estimated useful life. Ordinarily, the depreciation deduction is computed by applying a depreciation rate expressed as a percentage to the cost or other basis to be recovered, but it also may be computed by dividing that cost or other basis by the estimated useful life. The estimated useful life is subject to modification in the light of conditions known to exist at the end of each taxable period. Ordinarily, depreciation computed by this method represents the actual diminution in service value from year to year as closely as the depreciation computed by any other method. The practical simplicity in accounting records required and the ease and facility by which revisions or changing life estimates may be applied tend to make this method the most acceptable one for general use.

Unit of Production Method

This method is peculiarly applicable in determining depreciation for property used in the exploitation of natural resources, such as mineral deposits or timber, the available reserves of which limit the useful life of the depreciable property. Under such circumstances, the rate of exhaustion of the natural resource measures the useful life of the physical property. By dividing the cost or other basis less estimated salvage value by the estimated available reserves of raw material, a unit cost is obtained which, when multiplied by the units produced during a given year, gives the depreciation sustained for that year. Depreciation, at least to the extent of that based upon decay and normal obsolescence, is allowable and should be deducted during the period when property is idle or is producing at a rate below normal.

In the case of depreciable property the useful life of which is not limited by sources of supply, however, uncertain and unpredictable factors arise to such an extent as to make application of the method very difficult, if not impossible. Use of the method must be confined to those items in the property account whose lives are determined by the factors of wear and tear or where the extent of use or the rate of production measures the rate of exhaustion of the property. When such a separation can be made, it is then necessary to forecast for those items the useful lives of which are controlled by extent of use the total number of units to be produced during their useful lives, in order to obtain a cost factor to be applied

against units produced each year in arriving at the depreciation allowance. For most property it is not possible to obtain this information with any reasonable degree of accuracy and, therefore, the method is not considered an acceptable one for general application to the machinery account of industrial concerns, or to the property of those companies exploiting a natural resource with reserves sufficient to extend operations beyond the physical life of the original plant.

Declining Balance Method

Under this method the amount of depreciation is subtracted annually from the cost or other basis of the property and the rate applied only to the resulting balances. Depreciation on any single item is largest in amount the first year and declines each year thereafter. This method gives satisfactory results for accounts that are being constantly replaced in substantially equal amounts, provided the rate used is somewhat higher than that applicable under the straight-line method. Its best application is to those accounts for property in which the greater proportion of the production is confined to the early part of the useful life.

Retirement Accounting

In this form or method of accounting for a depreciable property, the cost of property retired each year is credited to the capital asset account and, less net salvage (actual or estimated), charged to expense in lieu of annual provisions for depreciation. . . .

Note

1. Bulletin "F" goes on to give probable useful lives for the assets used in a wide assortment of industries "based on the usual experience of property owners." For example, farmers are advised that farm buildings have a 50-year average life and farm machinery and equipment a 15-year average life. Moreover, separate estimates are given for each type of machinery and equipment (beehives, 10 years; cisterns, 33 years; milking machines, 20 years, tractors, 10 years; *etc.*) for those farmers who wish to keep a separate account for each class instead of a composite account. Although not binding on the taxpayer, these official estimates are likely to be influential with Bureau employees despite the admonition in Bulletin "F" that "in the determination of the depreciation allowance in each case, due consideration should be given the maintenance and replacement policy of the taxpayer and the accounting practice regarding the same."

2. The straight-line method of computing depreciation is by far the most commonly employed. The retirement method is largely restricted to railroads, where it has long been sanctioned by regulatory bodies for fixing rates. See, for an example of its use, *Commissioner* v. *Union Pacific R.R.*, 188 F.2d 950 (2d Cir. 1951). The declining balance method, or at least a peculiar variation of it, was authorized by the Bureau in 1946 as a method of encouraging post-war building construction, since it would permit larger than normal (*i.e.*, than straight line) deductions during the early years after construction when taxes were (it was thought) higher than they would be later. Mayer, "Declining Balance Depreciation," 25 *Taxes* 162 (1947)

The 1954 Code carries over without change the general provision of earlier law that the depreciation deduction shall be a "reasonable allowance" for exhaustion and wear and tear. It also provides that for certain property acquired or constructed after December 31, 1953, the term "reasonable allowance" shall include (but is not limited to) an allowance computed under certain specified methods; these are the straight line

method, the declining balance method, the "years-digit" method, and any other consistent method that will not during the first two-thirds of the property's life produce aggregate allowances greater than the declining balance method. The point of § 167(b) is to give statutory sanction to the use of several methods (in addition to any methods that are acceptable by virtue of the general provision for a "reasonable allowance") that will afford larger depreciation allowances during the earlier years of the property's life. To encourage new investment, this privilege is limited to post-1953 property. The declining balance method that is specifically allowed by § 167(b)(2) will permit approximately 40 per cent of an asset's cost to be depreciated in the first quarter of its service life, and two-thirds in the first half of its life. Section 167(b)(4), sanctioning any other consistent method that for the first two-thirds of the asset's life will not yield aggregate allowances greater than the declining balance method, permits the taxpayer to avoid certain technical drawbacks in the declining balance method that are explained in the Senate Report, pp. 26-27. The "years-digit" method can be best explained by illustration: assuming property with a useful life of 6 years, the taxpayer would take the sum of 1 + 2 + 3 + 4 + 5 + 6, or 21, and would take a deduction of 6/21 of the property's cost for the first year, 5/21 of its cost for the second year, *etc.* This method yields deductions that are comparable to the declining balance method.

3. Because of the difficulty of showing that one estimate of useful life is right and another wrong, and because disagreement in these estimates will affect only the year in which deductions will be taken, taxpayers have often urged that the Bureau accept whatever depreciation rate they select or at least that the taxpayer's rate be rejected only on the clearest proof that it is improper. The Bureau has felt to the contrary that manipulation would be encouraged if it were supine, so long as tax rates and income levels are fluctuating variables. In 1944 the Bureau did announce, however, that once a depreciation rate was investigated and adjusted by agreement with the taxpayer for a given year, it would ordinarily be accepted for at least five years. I.T. 3639, 1944 C.B. 123.

In 1953, the Bureau announced

> The determination of the amount of the [depreciation] deduction is largely a matter about which there may be reasonable differences of informed judgment, but the impact on the revenues resulting from these differences may be negligible one way or the other over the years involved. Accordingly, . . . it shall be the policy of the Service generally not to disturb depreciation deductions, and revenue employees shall propose adjustments in the depreciation deduction only where there is a clear and convincing basis for a change. (Rev. Rul. 90, 53-1 C.B. 43.)

Bureau employees were then advised that:

> Among the factors which should be given careful consideration in order to give full force and effect to the announced policy are the following:
>
> (a) Whether depreciation rates used by the taxpayer are fair and reasonable under the circumstances;
> (b) Whether the taxpayer has followed a consistent practice in arriving at the amount of depreciation deductions;
> (c) Whether in considering all factors, including reasonable tolerances, any adjustments proposed are substantial. (Rev. Rul. 91, 53-1 C.B. 44.)

It is of course too early to say how much effect an announcement of this kind will have on Bureau practice, or whether it will encourage taxpayers to use generally shorter lives in calculating depreciation deductions. It is interesting to recall, however, that as a result of precisely the opposite policy in the early 1930's taxpayers were compelled by the Bureau to employ longer lives for depreciable assets, and thereby succeeded against their will in saving some of their deductions for use when much higher tax rates came into effect during World War II.

The House version of the 1954 Code also provided that unless the government's estimate of the useful life of depreciable property differed from the taxpayer's estimate

by more than 10 per cent, the taxpayer's estimate could not be disturbed. The Senate eliminated this provision, stating (S. Rept. p. 28) that it

> would be considered inadequate and unsatisfactory by some taxpayers, and might be a substantial source of misunderstanding and distortion. The practical effect of eliminating this provision in assuring flexibility in administrative policy should not be great since policies already announced by the Internal Revenue Service under recent rulings should afford taxpayers freedom from annoying minor changes which would disturb the original estimate of service life.

Section 167(d), added by the 1954 Code, permits the government and the taxpayer to enter into written agreements relating to the useful life and rate of depreciation of any property, which "shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement."

4. The corollary of higher depreciation deductions is more gain (or less loss) if the property is disposed of before it is fully depreciated. Thus, if equipment costing $1000 has given rise to $400 in depreciation deductions, the taxpayer will realize $100 in gain if he sells it at $700, or $500 loss if he sells it to a junkman for $100. This is because the property's "adjusted basis" for determining gain or loss on a sale or other disposition is cost less depreciation; the property in question would have had an "adjusted basis" of $600. If the depreciation deductions had totalled $600, the adjusted basis would be only $400, and the taxpayer's gain on a sale at $700 would be $300, while the loss on a sale at $100 would be $300.

A bird in the hand is not necessarily better than two in the bush. Can a taxpayer, recognizing this, forego current depreciation deductions in order to retain a higher "adjusted basis" against the year when the asset is ultimately sold? No, because in computing the "adjusted basis" he must reduce his cost by any depreciation that was "allowable" in past years, whether he took it or not. Section 1016(a)(2). Moreover, if he took more than he was entitled to, that too must be applied against the cost of the asset unless the excessive depreciation was of no "tax benefit" when taken. This last qualification is a legislative overruling of *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523 (1943), see § 1016(a) (2) (A) and (B) and § 1020.

One of the factors of importance in this area, the full significance of which will appear more clearly after Chapter 5 has been studied, is that depreciation deductions are applied against ordinary income, whereas the countervailing profit on a sale (assuming the property is sold for more than its "adjusted basis") will often be taxed as capital gain, at a more lenient rate. Thus the taxpayer may be tempted to "trade" deductions against ordinary income for capital gain even when it is recognized that high current depreciation may have the effect of increasing profit (or decreasing loss) on the property's disposition.

5. In recent years, especially since the end of World War II, there have been a number of proposals for acknowledging in corporate financial statements that depreciation reserves based upon cost are inadequate to cover the replacement cost of equipment and plant as they are retired or scrapped. One method is to make an appropriation of earned surplus to a reserve for the excess of replacement cost over depreciation reserves based on cost. Another, more controversial, is to increase the depreciation deductions themselves, thus reflecting a smaller earned income in reports to stockholders, employees, government agencies, and the public. The income tax return, however, must still be prepared with depreciation based upon cost, and thus taxable income will exceed the income reported for other purposes. Finally, not surprisingly, it has been urged that taxable income should be adjusted to reflect replacement costs. This drastic proposal is extensively discussed in Brown, *Depreciation Adjustments For Price Changes* (1952). For a consideration of this and other problems in the relation of depreciation to investment, see Joint Committee on the Economic Report, *Factors Affecting Volume and Stability of Private Investment,* 81st Cong., 1st sess. (1949) 158–97.

COPIFYER LITHOGRAPH CORP. v. COMMISSIONER

Tax Court of the U. S., 1949
12 T.C. 728

[The taxpayer, which had customarily computed depreciation on its printing presses and equipment on a straight line basis, deducted depreciation in the amount of about $6,750 in 1942 and $9,400 in 1943 (in addition to straight line depreciation) because its plant was operated substantially longer hours in those years, mainly on war work. The additional depreciation was disallowed by the Commissioner.]

ARUNDELL, Judge: Petitioner contends in this proceeding that it is entitled to the increased deductions claimed in its tax returns for 1942 and 1943 to compensate for abnormal depreciation suffered by various items of its printing equipment in producing maps and other printed material for the armed forces during those years The deficiencies herein result from the respondent's refusal to allow any additional depreciation for either year.

Petitioner had in prior years depreciated its items of equipment on the straight line basis, assigning to each unit an estimated life of 10 years, with the exception of 2 trucks, which were assigned a 5-year period.

The straight line method of depreciation assumes a uniform annual rate over the life of the asset and, under ordinary circumstances, no adjustments are made to reflect the increased or decreased usage of the asset during any taxable year. This method contemplates the setting aside in each year of a sufficient sum in order that at the end of the useful life of the asset the aggregate of the annual amounts of allowed depreciation, plus its salvage value, will equal its original cost. *United States* v. *Ludey*, 274 U.S. 295; *Graves, Cox & Co.*, 27 B.T.A. 546. The straight line method having been uniformly applied by petitioner in prior years, it should not be abandoned for the years in question unless there is a cogent reason for a change. *Lake Charles Naval Stores*, 25 B.T.A. 173 (petition to review dismissed, C.C.A., 5th Cir.). However, petitioner contends that such factors as the excessive use of its machinery, its operation by inexperienced personnel, the demand of war work which prevented the normal stoppage of the machinery for repairs, and the increased amounts expended for repairs, replacements, and maintenance during the years involved, evidence the fact that the remaining useful life of such equipment was reduced and that petitioner is entitled to claim the additional depreciation involved herein. Essentially, the petitioner argues that the only plausible method of determining the extent of the increased wear and tear on its equipment during 1942 and 1943 was the approximate ratio between the usage in those years and the usage in prior years. The burden of showing the reasonableness of the rates of accelerated depreciation claimed rests upon the petitioner.

Had petitioner previously depreciated its equipment on a "unit of production" basis, this case would present little difficulty, as petitioner has clearly shown the increased usage of its various items of equipment during the years involved, which is the principal consideration in computing depreciation under that system. However, under the straight line basis, the principal question is whether the useful life of the equipment has been diminished, and usage is merely one factor to be

considered in making such a determination. Moreover, we believe that the straight line method contemplates reasonable variations from year to year in the use of depreciable assets, so long as the remaining useful life of the assets is not reduced below or extended beyond the term of years originally selected as its normal useful life.

Therefore, to prevail herein, the petitioner must justify the increased rate of depreciation it claims by showing not only that there were increased usage and other conditions which would normally tend to accelerate the exhaustion of its equipment, but that in fact such factors actually did materially reduce its useful life. *Woodside Cotton Mills*, 13 B.T.A. 266. In our opinion, petitioner has wholly failed to present satisfactory evidence that the useful life of its printing equipment was so reduced by usage in 1942 and 1943 as to warrant the substitution of accelerated rates in lieu of the normal rates it has previously used in computing depreciation.

Petitioner's general manager testified that when the rates of abnormal or accelerated depreciation were selected it had no way of determining how long its machinery would last and that no effort was made in either 1942 or 1943 to determine the remaining useful life of each of the various items of equipment involved. The only witness produced by petitioner who testified on the subject stated that under normal operations the 6 second-hand presses had an estimated useful life of from 10 to 15 years. As respondent has allowed petitioner to depreciate this equipment at a normal rate of 10 per cent on a straight line basis over a 10-year period, the minimum life estimate, respondent's disallowance of accelerated depreciation does not on its face appear to have been arbitrary or unreasonable. As far as we can ascertain from the record, the machines were never thoroughly examined to determine exactly the extent of actual exhaustion during the years in question, nor is there any specific evidence as to the effect of the use of inexperienced or incompetent help on the normal wear of such equipment. In fact, no evidence of any signficance has been presented by petitioner relative to items other than the photo composing machine and the 6 presses.

Petitioner points to the increased amounts expended by it on repairs, replacements, and maintenance as proof of the actual abnormal wear suffered by its machinery during 1942 and 1943. The untoward expenditures for repair do not necessarily demonstrate the deterioration of equipment, but may, on the contrary, be evidence that such repairs adequately compensated for the increased wear and tear to which the machines were subjected. This may well be the case here, as the record shows that the cost of repairs of the equipment in question rose from \$702.97 in 1941 to \$3,944.55 in 1942 and \$5,036.63 in 1943. Although there is some suggestion that this increase possibly was due to a rise in the cost of parts and labor, there is no evidence as to the extent of increased costs, and certainly there is no basis for assuming that these factors alone were responsible for so marked an increase in the cost of repairs

In this connection, it is also interesting to note that this equipment was at the time of hearing still being used in the petitioner's business. Although petitioner points out that it has been unable to get delivery of new machinery ordered in 1943, there is no indication that the old equipment does not still produce work of quality acceptable to its customers.

Finally, the various rates of accelerated depreciation selected by petitioner on its different pieces of equipment were not based upon actual examination of the machinery, nor were they computed by any uniform method. The rates appear to have been determined by petitioner's general manager, following discussions with its accountant and the manufacturer's representative, and to be the result of a general appraisal of such factors as the increased usage and repairs, untrained personnel, and the other factors previously mentioned.

Petitioner requests that, if we decide that it is not entitled to the accelerated depreciation claimed, we should determine what amount or rate of accelerated or abnormal depreciation should be allowed for the years 1942 and 1943. In our opinion, the record provides no adequate basis for the computation of rates of depreciation which would be more reasonable than those which were used by petitioner in prior years under the straight line method and have been allowed by respondent for the years involved Moreover, the computation of depreciation must be an intelligent estimate, not a mere guess. *Lake Charles Naval Stores*, *supra*.

After careful consideration of all the evidence herein, we are of the opinion that the petitioner has failed to sustain the burden of showing that it is entitled to the accelerated depreciation claimed by it in its 1942 and 1943 Federal tax returns. Therefore, respondent's determination of the deficiencies herein is sustained.

Note

Section 168 (the "cold" war's counterpart of § 124, in force during World War II) permits the taxpayer to amortize over a period of sixty months any "emergency facility," defined as an asset certified by an appropriate governmental office as necessary in the interest of national defense. War production equipment can thus be constructed or acquired with assurance that its cost can be written off during a period of high profits and tax rates, even though it may continue to be useful when the sixty-month period is over. See Schlaifer, Butters, and Hunt, "Accelerated Amortization," 29 *Harv. Bus. Rev. No. 3*, p. 113 (1951).

Canada has employed the depreciation deduction for precisely the opposite purpose: to discourage certain classes of capital investment. Unless the taxpayer obtains a certificate from the Ministry of Trade and Commerce, no depreciation on assets acquired after April, 1951 may be taken for a period of four years. See McGurran, "Deferred Depreciation," 4 *Nat'l. Tax J.* 299 (1951).

ADDA, INC. v. COMMISSIONER

Tax Court of the U. S., 1947
9 T. C. 199

JOHNSON, Judge: . . .

3. The third issue involves the deductible amount to which the petitioner is entitled as depreciation on its building. To determine this, two questions must be decided: (1) The cost of the building to the petitioner to be used as a basis in computing depreciation, and (2) the useful economic life of the building. Both questions are in dispute.

To ascertain what the building cost petitioner it is necessary to determine what amount of the total purchase price of $5,800,000 paid for the building and lot was attributable to the building alone. On the hearing petitioner offered evidence

that the reasonable amount of such total consideration for the building only was $1,500,000, while respondent's evidence fixed same at $1,150,000. It was evidently difficult for petitioner to determine the cost of the building, for in its income tax returns for both 1941 and 1942 it placed the cost of the building at $1,150,000, while in its petition for redetermination the cost of the building was alleged "to be not less than $1,740,000," and in its evidence and also in its brief filed herein such cost was placed at $1,500,000. After considering all the evidence upon this subject, we find that respondent's determination of the base value to be used in such computation, to wit, $1,150,000, is correct and the proper base. Such was the amount claimed by petitioner's own determination in its income tax returns for two years, and the evidence at the hearing fails to convince us that the valuation so determined by respondent was erroneous.

The other phase of this issue is whether the useful economic life of the building from the date of petitioner's acquisition was 36½ years as determined by respondent, or 20 years, as contended by petitioner.

There was evidence supporting both contentions, but, without reviewing it in detail, from all the facts and circumstances we have reached the conclusion that, while the structural integrity of the building is such that it may last for 40 years or more, as of August 5, 1940, it had an economic and useful life of not to exceed 21 years. Situated on Broadway near Times Square, it is one of the most valuable business sites in New York City, and the assessed taxable value of the building and lot for New York real estate taxes for 1941–1942 was $6,725,000, an increase in value of about one million dollars within a year after petitioner became its owner. The total floor space of the building is not sufficiently large to produce revenue commensurate with the value of the lot, and this disproportion will likely increase rather than diminish. When the building was constructed in 1935, its then owners realized its inadequacy to produce sufficient revenue for the valuable lot, but New York had not then recovered from the 1930 depression, there were fifteen million square feet of vacant office space in New York, and it was deemed inexpedient to erect a taller building, there being no demand then for additional space, and it would have been difficult to finance such construction at that time, so its builders determined to erect the present two-story structure, which is known in New York parlance as a "taxpayer," since it was designed to pay the real estate taxes plus some slight revenue, with the expectation that later it would be removed and a taller building erected. That such was in contemplation is evidenced by the fact that the leases to the various tenants of the building, with one exception, contained cancellation clauses at the option of the owner, two of the leases expressly providing for their cancellation "if landlord should decide to demolish the building." Not only the location, but the large size of the lot made it very desirable for the erection of a very tall building, the lot having a frontage of 203 feet on Broadway, extending from 44th to 45th streets, with a frontage on each of these streets of 183 feet and 256 feet, respectively. The building was so constructed that additional stories could not be added.

While it is impossible to forecast the future, we think it reasonable under the evidence to determine that, within a period of 21 years from the date of petitioner's purchase of the property, the present building will be removed and a much taller one erected that will produce revenue more in keeping with the value of the lot. Petitioner's contention is 20 years, but since the lease to Bond, the largest tenant,

covers 21 years from the date of purchase, we think it reasonable that the period of depreciation should be sufficiently long to cover the duration of this lease.

There was considerable evidence as to the expanding business of Bond Stores, Inc., the tenant which occupied most of the building, and the inadequacy of space for Bond's business. Respondent claimed that petitioner in effect was urging that, because petitioner was a 100 per cent subsidiary of Bond and owned by Bond, their interests should be treated in common, and respondent urged that, since they were two separate and distinct corporations, they should be so treated, regardless of ownership.

We find it unnecessary to pass upon these questions, since under the evidence we think that, regardless of who were the tenants of the building and their respective needs, the owner of the building, for economic reasons as was heretofore pointed out, will be required to demolish the building and erect another within the time indicated, designed to produce revenue more nearly commensurate with the value of the lot.

Note

If the owner of a building proves that a change in the neighborhood or other circumstances have substantially and permanently reduced the value of the building (although it will not be demolished), can he take a deduction for "extraordinary obsolescence?" Where property continues in use, despite diminution in its value, taxpayers have not been very successful in obtaining obsolescence deductions. See, for example, *Southeastern Building Corp.* v. *Commissioner*, 148 F.2d 879 (5th Cir. 1945). A deduction was allowed in *Hazeltine Corp.* v. *Commissioner*, 89 F.2d 513 (3d Cir. 1937), upon a showing that certain patents had "ceased to have any further practical utility or substantial earning power" prior to the end of their legal lives, by reason of a change in the art. What if the patents continued to have minor value by protecting the taxpayer's monopoly in manufacturing repair parts for equipment, although new equipment was no longer being manufactured because of technological changes? Is there any justification for demanding a very high degree of proof, or even of insisting upon total loss of utility, as a condition to the allowance for "extraordinary obsolescence" when ordinary depreciation and "normal obsolescence" are granted upon less proof? See generally Green, "What Deductions for Obsolescence?" *9th Annual N.Y.U. Inst. on Fed. Taxation* 701 (1951).

NACHMAN v. COMMISSIONER

U. S. Court of Appeals, Fifth Circuit, 1951
191 F.2d 934

Before HUTCHESON, Chief Judge, and HOLMES and STRUM, Circuit Judges.

STRUM, Circuit Judge.

These are two consolidated petitions to review decisions of the Tax Court which modified as to amount, but otherwise sustained, deficiency assessments in income taxes entered by the Commissioner of Internal Revenue against petitioners Nachman and Tobias for their fiscal tax year 1944–45.

Desiring to enter the retail liquor business as partners in Jacksonville, Florida, petitioners on April 25, 1944, purchased from one Baker Bryan for $8,000 an existing liquor license, good until September 30, 1944, issued to Bryan by the City of Jacksonville for $750, the fee fixed by ordinance therefor. The difference

between the official fee of $750 and the purchase price of $8,000 was a premium which Bryan was enabled to exact from petitioners because these licenses were restricted by law to approximately 76 for the entire City of Jacksonville, all of which were then issued. Many more persons desired them than could obtain them directly from the city, so they were in great demand, even at a premium. These licenses were assignable, and carried with them valuable renewal privileges, as it was the established practice in issuing renewal licenses from year to year to prefer the holders of existing licenses over other applicants. Because of this known practice, and the limited number of licenses available, persons wishing to enter the liquor business in Jacksonville were willing to pay a substantial premium in order to acquire a license from an existing licensee.

In making their income tax returns for the tax year involved, petitioners deducted as an ordinary and necessary business expense, the entire $8,000 paid for the license. The Commissioner disallowed all except 5/12th of the $750 annual fee, representing the unexpired portion of the license extending from April 25, 1944, the date of purchase, to September 30, 1944, when it expired. The Commissioner entered a deficiency assessment accordingly. On appeal, the Tax Court held that petitioners were entitled to deduct as ordinary business expense the entire $750 official fee, but no more, and reduced the deficiency accordingly. It is the latter determination by the Tax Court that petitioners bring here for review.

Of course it was necessary for petitioners to have a license before they could commence business. None could be procured directly from the City, as the maximum number allowed by law had already been issued. Like other scarce commodities, they commanded a premium on a seller's market. The license carried with it by established custom, if not by law, a valuable renewal privilege indispensable to petitioners' continuance in business in subsequent years. In purchasing the license, petitioners bought not only the operating right for the current year but also renewal privileges for future years. This privilege, entitling petitioners to preference over non-license holders in the issuance of renewal licenses, was of substantial value, of which the seller and the purchasers of this license were well aware. No one would pay $8,000 for a $750. license having only five months to run, unless the purchaser was reasonably sure it carried with it appurtenant privileges of substantial future value to the purchaser. It was these considerations that prompted petitioner to pay $8,000 for a $750 license, of which only 5/12ths remained.

Of the $8,000 paid for the license in question, the official cost of issuance, $750, was an ordinary and necessary business expense. The remaining $7,250 was the expenditure of capital in the acquisition of a capital asset reasonably expected to serve petitioners through future years, the cost of which is not deductible as an ordinary expense. . . . The Supreme Court of Florida has recently recognized a liquor license as "property," often having an actual value far in excess of the official fee charged for it. *House* v. *Cotton*, 52 So.2d 340.

Petitioners further contend that if the $7,250 in question be regarded as the purchase price of a capital asset and therefore not deductible as ordinary business expense, they are entitled to an amortized depreciation allowance on such capital asset under I.R.C. § 23, and Treasury Regs. 118, Sec. 39.23(l)–3, relating to depreciation of intangible property. Depreciation allowance on intangibles, however, is confined to those definitely limited in duration, such as patents, franchises,

copyrights, licenses for fixed periods, and the like, the partial exhaustion of which may be computed with reasonable certainty.

It is clear that the renewal privilege appurtenant to this license extends beyond, and was actually exercised beyond, the taxable year in question. Presumably the petitioners may continue to exercise their renewal privileges as long as they desire, as there is no indication that the City will depart from its custom of renewing existing licenses. How long petitioners may wish to continue exercising their renewal privileges is indeterminable. It might be for one year, or many. It was exercised by them at least as late as 1949. The basis for depreciation of an intangible capital asset is partial exhaustion due to lapse of time. This renewal privilege being of indefinite duration, dependent upon petitioners' wishes as well as upon the City's future course of action, there is no rational basis for prediction as to duration.

Moreover, if petitioners elect to discontinue the exercise of their renewal rights, it is reasonable to assume that they will sell them, just as did their predecessor Bryan, either recouping their investment or sustaining a deductible loss. We conclude therefore, as did the Tax Court, that the renewal privilege incident to the license is a nondepreciable capital asset. *Clark Thread Co.* v. *Commissioner*, 3 Cir., 100 F.2d 257.

We have examined the cases cited by the petitioners in support of their contensions, but consider them inapposite here.

Affirmed.

Note

1. The Court's treatment of the cost of the license is in line with the usual treatment of expenses to acquire goodwill. the theory has been that the goodwill continues to serve the taxpayer as long as he remains in business and, if it is worthless when the business is wound up, its cost will be deductible at that time. Regs. 118, Sec. 39.23(1)-3; see generally Note, An Inquiry Into the Nature of Goodwill, 53 *Col. L. Rev.* 660(1953). Almost always, of course, the taxpayer would prefer to amortize the capitalized cost of goodwill during his successful years if he were permitted to do so, rather than wait for a large deduction in what may be a loss year. See *X-Pando Corp* v. *Commissioner*, 7 T.C. 48(1946), Note, 62 *Yale L.J.* 640(1953). In *Williams* v. *McGowan*, 152 F.2d 570(2d Cir. 1945), Judge L. Hand, despite the regulations, adhered to an earlier announced view that good will is depreciable. Even if in theory it is depreciable, however, in practice it may be impossible to prove a limited useful life.

2. So long as taxpayers are unable to depreciate goodwill, either because of the blanket disapproval of the regulations or because of the difficulty of proving a limited life, they will be particularly eager to deduct advertising expenses, for if these expenses are capitalized, they may never be recovered out of income. Much advertising is, of course, devoted to creating goodwill; this is especially true of "institutional advertising" and of publicity for a new trade name or product. It may be noted that for excess profits tax purposes taxpayers were permitted to capitalize certain advertising expenditures [those that "may be regarded as made for the purpose of increasing the taxpayer's earning capacity over a substantial period subsequent to the taxable year in which such expenditure was made," see Regs. 130, Sec. 40.451-2 (a)] in order to increase the excess profits credit. If this option was exercised, the taxpayer was required to pay the additional income tax that resulted from eliminating the deducted expenditures. Except in unusual circumstances, the Bureau seems to acquiesce in the deduction of advertising expenses, even though capitalizing them might theoretically be more appropriate. See I.T. 3581, 42-2 C.B. 88. See also § 173, on expenses "to establish, maintain, or increase" the circulation of a newspaper or periodical.

The expenses of organizing a corporation, which would not be deductible because they represent a long-term investment and which would not be depreciable unless the corporation had a limited existence, may now be written off over a period of five years or more if the corporation elects to do so. Section 248, added by the 1954 Code.

3. A related problem is the treatment of research and development expense. Before 1954, these items were not specifically dealt with by the statute, but the government apparently allowed them to be deducted so long as that was the taxpayer's accounting practice. 53-2 P-H Fed. Tax Serv. ¶ 11,095. If instead they were capitalized, the investment could be depreciated if allocable to patents or other intangibles of limited life or written off if the project was a failure, but if the investment was represented by industrial "know-how," the taxpayer would probably be unable to prove that it had a limited life. See *Hart-Bartlett-Sturtevant Grain Co.* v. *Commissioner*, 182 F.2d 153 (8th Cir. 1950).

See Section 174 of the 1954 Code, specifically authorizing research and experimental expenses to be deducted and permitting the taxpayer to amortize certain expenditures of this type. What is the significance of § 174(b)(1)(C)?

See also § 175, allowing farmers to deduct, within specified limits, expenditures for soil and water conservation and the prevention of erosion.

4. The Commissioner has long conceded the propriety of depreciating the cost of patents, copyrights, contracts, and other intangibles with a limited legal life. But what if the taxpayer buys a patent having 10 years to run with the well-founded expectation that within 5 years its position in the industry will be impregnable, so that the patent will have been just as useful as though its life had been unlimited?

4. Depletion

> ***Note:*** **Sections 23(m) and 114(b) of the 1939 Code, relating to depletion, have been reenacted, with some modifications, by §§ 611 and 613 of the 1954 Code.**

Although the *Baltic Mining Co.* case, *supra*, p. 64, held that an allowance for depletion of natural resources was not a constitutional necessity, Congress has allowed depletion to be deducted since 1913.

Originally, the deduction was based upon the cost of the property being depleted, and "cost depletion" is still authorized. When this method is employed, the taxpayer allocates his adjusted basis (cost, value as of March 1, 1913, or basis otherwise determined) equally among the estimated recoverable units and deducts an appropriate amount as the units are mined. Thus, if the cost to be allocated is $100,000 and there are 100,000 recoverable tons, the depletion allowance will be $1 per ton, deducted as the ore is mined. The provision considered in the *Baltic Mining Co.* case, providing that the depletion allowance might not in any circumstances exceed 5 per cent of gross income, was repealed in 1916.

Until 1954, a second authorized method of computing depletion was to use "discovery value" as the amount to be recovered tax-free by the taxpayer. This method, first granted as an incentive to exploration in 1918, permitted the taxpayer to take the fair market value of the mine at the time of discovery or within 30 days thereafter and to allocate this amount (no matter how much it exceeded his cost) among the recoverable units to find the depletion allowance per unit. See *Holloway* v. *Commissioner*, 21 T.C. 40 (1953). Although popular at one time, this method was seldom encountered in recent years, because it was not allowed for

deposits entitled to percentage depletion, and these constituted an ever-widening group. The 1954 Code makes percentage depletion generally available, and thus discovery value depletion is no longer authorized.

The percentage depletion method ignores both the taxpayer's cost and the number of recoverable units. Instead, the taxpayer is permitted to deduct a given percentage of his gross income (but not to exceed 50 per cent of taxable income calculated before depletion is taken) as a depletion allowance. This method avoids the problem, common to both cost and discovery value depletion, of estimating the number of recoverable units in the deposit in question, an estimate that may be only the wildest of guesses. For the taxpayer, percentage depletion has the special attraction of increasing the depletion allowance when income rises, which ordinarily is when the deduction will save most in taxes. Even more important, percentage depletion just keeps rolling along, even after the taxpayer's full cost or discovery value has been recovered. This feature is not an essential of percentage depletion, since the taxpayer *could* be restricted in his total life-time recoveries to the cost or discovery value of the deposit, but the statute does not now contain such a limitation. Percentage depletion is of particular importance in the petroleum industry (27½ per cent being the figure applicable to oil and gas), but it is now generally available.

There are a number of technical problems in calculating percentage depletion, including the determination of which of the extraordinarily varied interests in oil and gas are entitled to take depletion. See Beveridge, *Federal Taxation of Income from Oil and Gas Leases* (1948), Baker, "The Nature of Depletable Income," 7 *Tax L. Rev.* 267 (1952). The hotly debated issues of policy posed by this allowance are acutely summarized by Dean Griswold and Mr. Rex G. Baker in "Percentage Depletion—A Correspondence," 64 *Harv. L. Rev.* 361 (1951); see also Eldridge, "Tax Incentives for Mineral Enterprise," 58 *J. Pol. Econ.* 222 (1950); Galvin, "Federal Income Tax—Percentage Depletion of Oil and Gas Wells," 21 *Texas L. Rev.* 410 (1943), Jackson, "Federal Income Tax Percentage Depletion of Oil and Gas Wells—Another View," *id.* 798, Note, 60 *Harv. L. Rev.* 606 (1947). For a proposal to make everyone rich, see Blum, "How to Get All (But All) the Tax Advantages of Dabbling in Oil," 31 *Taxes* 343 (1953).

In 1951, some of the extractive industries gained the unusual option of capitalizing or "expensing," as the taxpayer chooses, certain costs of exploration and development that would otherwise have to be capitalized. Sections 615 and 616. Ordinarily, of course, a taxpayer who writes off items to expense simply accelerates a tax benefit that he would otherwise obtain (if he capitalized them) through increased depreciation or depletion or an increased basis for calculating gain or loss on sale. But if percentage depletion is used, since it is not geared to the basis of the property, the right to "expense" an item is unusually advantageous. See Alexander and Grant, "Mine Development and Exploration Expenditures," 8 *Tax L. Rev.* 401 (1953).

The 1951 amendments did not include the oil and gas industry. But for some years, the Regulations have permitted the oil and gas taxpayer either to expense or to capitalize intangible drilling and development costs. Regs. 118, Sec. 39.23(m)–16. Drilling and development costs that are reflected in tangible equipment are not included in this option; they must be capitalized and recovered

by depreciation deductions. But the *intangible* costs would ordinarily be attributed to the cost of the oil and gas and thus be recovered through the depletion allowance. Since percentage depletion is not limited by the deposit's cost, the taxpayer will usually prefer to "expense" his intangible costs. Consternation was created in the industry in 1945 when the Court of Appeals for the Fifth Circuit, in *F.H.E. Oil Co.* v. *Commissioner*, 147 F.2d 1002 (5th Cir. 1945), held that the regulations were invalid in permitting the taxpayer to deduct a capital expenditure. The opinion was somewhat modified on rehearing, after briefs had been filed by thirty counsel for other oil producers, appearing *amici curiae*, alleging that a billion dollars of deductions were imperiled by the opinion. *F.H.E. Oil Co.* v. *Commissioner*, 149 F.2d 238 (5th Cir. 1945). A few weeks later Congress passed a concurrent resolution declaring that it had approved the questioned regulations by reenacting § 23 of the 1939 Code with knowledge of the Treasury's interpretation of it. 59 Stat. (Part 2) 844 (1945). What is the effect of such a resolution? *F.H.E Oil Co.* v. *Commissioner*, 150 F.2d 857 (5th Cir. 1945); Gibson, "Congressional Concurrent Resolutions An Aid to Statutory Interpretation?" 37 *A.B.A.J.* 421 (1951).

5. *The Optional Standard Deduction*

> **Note: Section 23(aa) of the 1939 Code, relating to the standard deduction, is reenacted without substantive change by §§ 141-144 of the 1954 Code.**
>
> **Section 22(n) of the 1939 Code, defining "adjusted gross income," is reenacted with two substantive changes by § 62 of the 1954 Code.**
>
> **See also Section 36 of the 1954 Code, corresponding to § 23 (aa)(2) of the 1939 Code.**

The optional standard deduction, *supra*, p. 157, displaces all personal deductions if elected. It also displaces certain of the deductions considered in this chapter.

1. Trade or business expenses. These expenses are allowed in addition to the optional standard deduction, except that if they are incurred by the taxpayer "in connection with the performance by him of services as an employee," they can be deducted only if they consist of (a) expenses paid by him under a reimbursement or other expense allowance arrangement with his employer, (b) expenses of travel, meals, and lodging while away from home, (c) expenses of transportation, or (d) trade or business expenses of an "outside salesman."

A surprising volume of litigation, considering the small amounts ordinarily involved, has been required as a result of this treatment of the employee. In the first place, when is a taxpayer an independent contractor, not an employee, so as to be entitled to deduct all trade and business expenses in addition to the standard deduction? *Kershner* v. *Commissioner*, 14 T.C. 168 (1950); *Meisinger* v. *Commissioner*, ¶ 52,178 P-H Memo TC.

Secondly, what is a "reimbursement or other expense allowance arrangement?" *McKinney* v. *Commissioner*, ¶ 48,265 P-H Memo TC. Apparently an employee can get the benefit of all of his trade or business expenses, as well as the optional

standard deduction, if his employer will only reimburse expenses separately from the salary, instead of paying a larger salary and expecting the employee to pay the expenses himself.

The 1954 Code liberalized this area somewhat by allowing items (c) and (d) above to be deducted; previously, only items (a) and (b) were allowable. Item (c) takes care of automobile expenses incurred by employees who return home every night; and item (d) allows "outside salesmen" (as defined by § 62(2)(D) to deduct telephone and telegraph, secretarial, and entertainment expenses in addition to the standard deduction.

2. *Expenses of profit-seeking transactions.* By electing the optional standard deduction, the taxpayer forfeits certain of the deductions otherwise available under §§ 212 and 165. Deductions attributable to property held for the production of rents and royalties are still allowable. But expenses attributable to other property held for income (e.g., securities) are not allowed, nor are losses on transactions entered into for profit if there is no sale or exchange of property.

Upon what theory—or theories—did Congress promulgate these rules governing the deductions* that must be foresworn if the standard deduction is elected?

Note the link between the standard deduction and "adjusted gross income"; the deductions that are used to convert gross income into adjusted gross income are the same ones that may be deducted in addition to the standard deduction.

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* Certain credits are also denied if the standard deduction is taken. § 36

CHAPTER 4

THE SPLITTING OF INCOME

Section A. The Advantages of Community Property

POE v. SEABORN

Supreme Court of the U. S., 1930
282 U.S. 101

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Seaborn and his wife, citizens and residents of the State of Washington, made for the year 1927 separate income tax returns. . . .

During and prior to 1927 they accumulated property comprising real estate, stocks, bonds and other personal property. While the real estate stood in [the husband's] name alone, it is undisputed that all of the property real and personal constituted community property and that neither owned any separate property or had any separate income.

The income comprised Seaborn's salary, interest on bank deposits and on bonds, dividends, and profits on sales of real and personal property. He and his wife each returned one-half the total community income as gross income and each deducted one-half of the community expenses to arrive at the net income returned.

The Commissioner of Internal Revenue determined that all of the income should have been reported in the husband's return, and made an additional assessment against him. Seaborn paid under protest, claimed a refund, and on its rejection, brought this suit.

The District Court rendered judgment for the plaintiff [32 F.(2d) 916]; the Collector appealed, and the Circuit Court of Appeals certified to us the question whether the husband was bound to report for income tax the entire income, or whether the spouses were entitled each to return one-half thereof. This Court ordered the whole record to be sent up. 281 U.S. 704, 50 S. Ct. 459, 74 L. Ed. 1128.

The case requires us to construe sections 210(a) and 211(a) of the Revenue Act of 1926,* and apply them, as construed, to the interests of husband and wife

* These sections provided that the normal tax and the surtax "shall be levied, collected, and paid for each taxable year upon the net income of every individual" Substantially the same language now appears in Section 1(a) of the Code [Ed]

in community property under the law of Washington. These sections lay a tax upon the net income of every individual. The Act goes no farther, and furnishes no other standard or definition of what constitutes an individual's income. The use of the word "of" denotes ownership. It would be a strained construction, which, in the absence of further definition by Congress, should impute a broader significance to the phrase.

The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the law of the State, as to a wife's ownership of or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor?

The answer is found in the statutes of the State, and the decisions interpreting them.

These statutes provide that, save for property acquired by gift, bequest, devise or inheritance, all property however acquired after marriage, by either husband or wife, or by both, is community property. On the death of either spouse his or her interest is subject to testamentary disposition, and failing that, it passes to the issue of the decedent and not to the surviving spouse. While the husband has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co-owner. The wife may borrow for community purposes and bind the community property. *Fielding* v. *Ketler*, 86 Wash. 194, 149 P. 667. Since the husband may not discharge his separate obligation out of community property, she may, suing alone, enjoin collection of his separate debt out of community property. *Fidelity & Deposit Co.* v. *Clark*, 144 Wash. 520, 258 P. 35. She may prevent his making substantial gifts out of community property without her consent. *Parker* v. *Parker*, 121 Wash. 24, 207 P. 1062. The community property is not liable for the husband's torts not committed in carrying on the business of the community. *Schramm* v. *Steele*, 97 Wash. 309, 166 P. 634.

The books are full of expressions such as "the personal property is just as much hers as his" (*Marston* v. *Rue*, 92 Wash. 129, 159 P. 111, 112); "her property right in it [an automobile] is as great as his" (*Id.*, 92 Wash. 133, 159 P. 111, 113); "the title of one spouse therein was a legal title, as well as that of the other" (*Mabie* v. *Whittaker*, 10 Wash. 663, 39 P. 172, 175).

Without further extending this opinion it must suffice to say that it is clear the wife has, in Washington, a vested property right in the community property, equal with that of her husband; and in the income of the community, including salaries or wages of either husband or wife, or both. A description of the community system of Washington and of the rights of the spouses, and of the powers of the husband as manager, will be found in *Warburton* v. *White*, 176 U.S. 484, 20 S. Ct. 404, 44 L. Ed. 555.

The taxpayer contends that if the test of taxability under Sections 210 and 211 is ownership, it is clear that income of community property is owned by the community and that husband and wife have each a present vested one-half interest therein.

The Commissioner contends, however, that we are here concerned not with

mere names, nor even with mere technical legal titles; that calling the wife's interest vested is nothing to the purpose, because the husband has such broad powers of control and alienation, that while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered for the purposes of sections 210 and 211. He points out that as to personal property the husband may convey it, may make contracts affecting it, may do anything with it short of committing a fraud on his wife's rights. And though the wife must join in any sale of real estate, he asserts that the same is true, by virtue of statutes, in most States which do not have the community system. He asserts that control without accountability is indistinguishable from ownership, and that since the husband has this, quoad community property and income, the income is that "of" the husband under sections 210, 211 of the income tax law.

We think in view of the law of Washington above stated this contention is unsound. The community must act through an agent. This Court has said with respect to the community property systems (*Warburton* v. *White*, 176 U.S. 494, 20 S. Ct. 404, 408, 44 L. Ed. 555) that "property acquired during marriage with community funds became an acquêt of the community and not the sole property of the one in whose name the property was bought, although by the law existing at the time the husband was given the management, control, and power of sale of such property. This right being vested in him, not because he was the exclusive owner, but because by law he was created the agent of the community."

In that case, it was held that such agency of the husband was neither a contract nor a property right vested in him, and that it was competent to the legislature which created the relation to alter it, to confer the agency on the wife alone, or to confer a joint agency on both spouses, if it saw fit—all without infringing any property right of the husband. See, also, *Arnett* v. *Reade*, 220 U.S. 311, at page 319, 31 S. Ct. 425, 55 L. Ed. 477, 36 L. R. A. (N.S.) 1040.

The reasons for conferring such sweeping powers of management on the husband are not far to seek. Public policy demands that in all ordinary circumstances, litigation between wife and husband during the life of the community should be discouraged. Law-suits between them would tend to subvert the marital relation. The same policy dictates that third parties who deal with the husband respecting community property shall be assured that the wife shall not be permitted to nullify his transactions. The powers of partners, or of trustees of a spendthrift trust, furnish apt analogies.

The obligations of the husband as agent of the community are no less real because the policy of the State limits the wife's right to call him to account in a court. Power is not synonymous with right. Nor is obligation coterminous with legal remedy. The law's investiture of the husband with broad powers, by no means negatives the wife's present interest as a co-owner.

We are of opinion that under the law of Washington the entire property and income of the community can no more be said to be that of the husband, than it could rightly be termed that of the wife.

[The Court then held that certain Congressional actions were not intended to forbid the division of community income between husband and wife.]

The Commissioner urges that we have, in principle, decided the instant question in favor of the Government. He relies on *United States* v. *Robbins*, 269 U.S.

315, 46 S. Ct. 148, 70 L. Ed. 285; *Corliss* v. *Bowers,* 281 U.S. 376, 50 S. Ct. 336, 74 L. Ed. 916, and *Lucas* v. *Earl,* 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731.

In the *Robbins* Case, we found that the law of California, as construed by her own courts, gave the wife a mere expectancy and that the property rights of the husband during the life of the community were so complete that he was in fact the owner. Moreover, we there pointed out that this accorded with the executive construction of the Act as to California.

The *Corliss* Case raised no issue as to the intent of Congress, but as to its power. We held that where a donor retains the power at any time to revest himself with the principal of the gift, Congress may declare that he still owns the income. While he has technically parted with title, yet he in fact retains ownership, and all its incidents. But here the husband never has ownership. That is in the community at the moment of acquisition.

In the *Earl* Case a husband and wife contracted that any property they had or might thereafter acquire in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, "shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants. . . ." We held that assuming the validity of the contract under local law, it still remained true that the husband's professional fees, earned in years subsequent to the date of the contract, were his individual income, "derived from salaries, wages, or compensation for personal service," under sections 210, 211, 212 (a) and 213 of the Revenue Act of 1918 (40 Stat. 1062–1065). The very assignment in that case was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which it could operate. That case presents quite a different question from this, because here, by law, the earnings are never the property of the husband, but that of the community.

Finally the argument is pressed upon us that the Commissioner's ruling will work uniformity of incidence and operation of the tax in the various states, while the view urged by the taxpayer will make the tax fall unevenly upon married people. This argument cuts both ways. When it is remembered that a wife's earnings are a part of the community property equally with her husband's, it may well seem to those who live in states where a wife's earnings are her own, that it would not tend to promote uniformity to tax the husband on her earnings as part of his income. The answer to such argument, however, is, that the constitutional requirement of uniformity is not intrinsic, but geographic. *Billings* v. *United States,* 232 U.S. 261, 34 S. Ct. 421, 58 L. Ed. 596; *Head Money Cases,* 112 U.S. 580, 5 S. Ct. 247, 28 L. Ed. 798, *Knowlton* v. *Moore,* 178 U.S. 41, 20 S. Ct. 747, 44 L. Ed. 969. And differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. *Florida* v. *Mellon,* 273 U.S. 12, 47 S. Ct. 265, 71 L. Ed. 511.

The District Court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective incomes, and its judgment is affirmed.

The Chief Justice and Mr. Justice Stone took no part in the consideration or decision of this case.

Note

1. In common law property states, if the husband makes an outright gift of property, such as securities or real estate, to the wife, the income subsequently produced by the property is taxed to her. If he transfers the property into a joint tenancy or a tenancy in common with his wife, the income will be divided between them for tax purposes; and the same result will follow if the property is transferred into a tenancy by the entirety unless under local law the husband is entitled to all the income. See Rudick, "Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety," 4 *Tax L. Rev.* 3, 25–29(1948). But ordinarily the common law couple cannot split up the husband's *earned* income for tax purposes, as will be seen *infra*, p. 298 and splitting of investment income will be jeopardized if the husband retains control over either the transferred property or the income. With respect to both earned and unearned income, then, there was a world of difference between the Northeast and the Southwest.

2. As income tax rates rose just before and during World War II, the community property system spread. In 1939 Oklahoma enacted an optional system and Oregon did the same in 1943; both had community property neighbors and were to a degree concerned about migration for tax advantages. These statutes were repealed, however, when the Supreme Court held in *Commissioner* v. *Harmon,* 323 U S. 44 (1944), that an optional system, not "dictated by State policy, as an incident of matrimony," could not claim the mantle of *Poe* v. *Seaborn,* and were later replaced by mandatory systems. During this period Hawaii, Nebraska, Michigan, and Pennsylvania * also adopted the community property system, despite their lack of historical or geographical connection with Spanish law, and adoption was under discussion in several other states, including New York. Against this background Congress enacted the "income-splitting" provisions of the Revenue Act of 1948.

Section B. Income-Splitting Under the Revenue Acts of 1948 and 1951

Note: **Section 6013 of the 1954 Code prescribes the qualifications for and method of filing a joint return, and § 2 states how the tax is to be computed. Section 1(b) gives the rates for a "head of a household," and defines this term. See also the tax table in Section 3.**

These sections of the 1954 Code carry over the basic principles of §§ 51(b), 12(d), and 12(c)(3)-(5) of the 1939 Code, with some modifications.

See Regs. 118, Secs. 39.51-1, 39.12-3, and 39.12-4.

SURREY
FEDERAL TAXATION OF THE FAMILY— THE REVENUE ACT OF 1948

61 Harv. L. Rev. 1097, 1103–11 (1948).
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Background. The Revenue Act of 1948 permits a husband and wife to split their combined income in half for the purpose of computing their federal in-

* Pennsylvania's statute was held unconstitutional. Willcox v. Penn Mutual Life Insurance Co., 357 Pa. 581, 55 A.2d 521(1947).

come tax. To the long history of the treatment of family income, the Act thus adds a chapter which is likely to be the last for many years. The preceding chapters are familiar even to non-tax experts, for this phase of federal taxation has been widely discussed. Writing in 1946 and urging consideration of the split-income plan, I summarized the situation that existed prior to the new Act.

The present treatment of family income is vulnerable to indictment on at least two serious counts. It is a fertile breeding ground of costly, difficult and wasteful litigation. It is sadly lacking in tax equity, since it involves both geographical discrimination between families in community property states and those in non-community property states and qualitative discrimination between families receiving earned income and those possessing investment income. These discriminations dollarwise are highly inequitable at present tax rates. Judicial safeguards devised to protect the progressive surtax have not provided a rational system. The alternative legislative solutions to these difficulties are mandatory joint returns or per capita division between husband and wife. At the level of the family, the latter solution of per capita division appears politically feasible. Considered relative to the treatment of single persons, the adoption of the per capita system may perhaps involve some discrimination in favor of the family unit. But the extent of the discrimination so created is difficult of positive proof and measurement. At any event, it does not appear to be as serious as the present admitted inequalities among married couples. The double need of eliminating both these inequalities and the excessive litigation they promote would appear to outweigh the possible claims of single persons.[1]

Against this background, four main factors emerged in 1946 and 1947 to lead to the adoption in the new Act of splitting of income between husband and wife for federal tax purposes (1) Four states, Oregon, Nebraska, Michigan, and Pennsylvania, emulated Oklahoma in adopting the community property system solely to reduce taxes for their residents. Other states were willing to follow if the step became necessary. It was recognized that such resort overnight to unfamiliar and complicated property relationships should not be forced upon the states as the remedy for a defect in the federal tax structure. (2) The Treasury Department indicated that the split-income solution was an acceptable answer to the problem. (3) Tax-wise married citizens in the middle and upper brackets suddenly perceived the application to tax reduction of Shakespeare's aphorism respecting the rose. Split income would not only give them even more than the widely publicized but politically impossible Knutson 20% slash, but could also be respectably defended as tax reform. (4) Politically astute legislators recognized that split income, plus a hastily picked-up companion, split estates and gifts, would assure the votes necessary for victory in the running tax battle with the President.

Thus, a far-reaching change in the income taxation of the family was accomplished. Those who preferred other solutions were not realists, or rather not presently realistic. As Chairman Millikin replied to a witness who urged mandatory joint returns:

I may refresh your memory; we tried it several times. The only difference [difficulty?] with it is that you can not get the votes to make a law out of it.

And to a witness who urged the legislative reversal of *Poe* v. *Seaborn* so as to tax the earner of community property income, a solution that would not meet

[1] Surrey, *Family Income and Federal Taxation*, in National Tax Association, Proceedings of 39th National Conference 357, 368 (1946), reprinted in 24 *Taxes* 980, 987 (1946).

the noncommunity earned-versus-unearned-income aspect of the problem, he stated:

> The difficulty is that it is not a novel thought. It has been tossed in the hopper around here a number of times. But legislatively it has not been possible to do it

While adoption of the split-income solution means a significant tax reduction for most middle-and upper-bracket taxpayers, this aspect must be judged in a broader setting. Reliance solely on the percentage-of-tax method of reduction, the alternative in these brackets to the split-income reduction, would have meant as large a reduction for these brackets considered as a group. But many community property families, non-community property families with split investment income, and single persons, would have shared equally in such a reduction. In short, these brackets as a group would have received the same tax reduction, but the inequitable discriminations among families therein—the entire problem—would have remained. If tax reduction of this magnitude was to be afforded these brackets, it was wise tax policy to use the dollars of tax reduction to accomplish needed reform and build an improved tax structure. The best chance for a more equitable and economically more effective tax system lies in the intelligent allocation of any tax reduction. The adoption of a presently acceptable solution to the family income problem represents the one bright spot in the Revenue Act of 1948.

Technical Operation. An examination of the technical operation of the split-income plan reveals that fortunately it has not added to the complexity of the federal tax system. The plan revolves entirely around the utilization of a familiar device, the voluntary joint return filed by husband and wife. If such a return is filed, the combined net income is computed in the customary manner under that return. The items of income and deduction and the credits of each spouse are aggregated. Then—and this is the departure from the joint return as it formerly existed—the net income and the credits are divided by one-half, and a preliminary tax computed on the basis of the resulting figures. This preliminary tax is then multiplied by two to produce the final total tax for husband and wife.*

Accompanying this change in computation are related statutory changes in the allowance of two deductions. The maximum limitation on the 10% standard deduction is increased from $500 to $1000, thereby permitting, for a joint return, the total amount hitherto obtainable through two separate returns in community property states.† To prevent continued advantage in the latter case, the $500 limitation is retained for a married individual filing a separate return. Similarly, the maximum allowable medical expense deduction is increased to $5,000 for a joint return (available in the case of a married couple with at least two dependents), but restricted for a separate return to the present limitation of $2500 (available in the case of a taxpayer with at least one dependent).‡

One other change pertaining to the standard deduction may be noted. The increased maximum limitation of $1000 is also made available to unmarried taxpayers, the reason being stated in the Senate Report as follows: "The fact that married couples in all States may receive a maximum standard deduction of $1000

* Sections 6013 and 2(a). [Ed.]

† Section 141. [Ed.]

‡ These limits were doubled by the 1954 Code and a head of a household is now on a par with a married couple. [Ed.]

presents a problem of equalizing the treatment accorded married persons with single individuals. To provide equality of tax treatment it is necessary to raise the maximum standard deduction for single persons to $1000."

This ratiocination will not pass muster. It would have been equally applicable to the medical expense deduction where the single person is restricted to the former $2500 limitation. And, obviously, equality between single persons and married couples at the same income level is just what the split-income plan of necessity eliminates. Formerly, except for the extra $500 exemption, the tax of a married couple (where one spouse had all the income) was the same as that of a single person possessing the same amount of income. But under the split-income plan, if we except the standard deduction, the income tax of the married couple is now equal only to twice that of a single person possessing one-half of their income. Under progressive rates, the tax is considerably less when computed according to the latter method, and this was the crux of the whole community property, assigned-investment-income problem. Equality among married couples at the same income level—and not equality in tax dollars with single persons at that level—is the essence of the split-income plan. As has already been mentioned, this plan accepts the view that tax equity is satisfied, relative to single persons, by regarding the married couple as equal to two single persons each with one-half the combined income. Under these premises, the standard deduction for single persons should have remained limited to $500.

This provision increasing the unmarried taxpayer's standard deduction, however, may be supported on other grounds. It can be argued that consumption economies present in marriage, as in rent and furniture, might justify a tax on the married couple higher than that of twice the tax on a single person with one-half the combined income, though not approaching that of a single person with the same income, which was the former situation. These economies cannot yet be determined with precision. The allowance of the second $500 standard deduction to the single person can therefore be accepted as a device roughly to compensate for these economies. . . . Since the joint return will become almost universal for married couples, the Act and the accompanying Committee Reports contain a fairly detailed set of rules respecting its use. Some of the rules are familiar; others are innovations. The Senate Committee Report states the basic tenet: "Although there are two taxpayers on a joint return, there is only one net income." Hence, without express statutory provision, two personal exemptions are available but only one standard deduction. The Act defines the marriage status necessary for resort to the joint return,[2] limits the use of joint returns in the case of husband and wife with different taxable years,[3] permits their use under prescribed conditions in the event of the death of one or both spouses,[4] provides that the tax liability shall be

[2] Section 6013. The status is to be determined, except in cases of death, at the close of the taxable year. It is provided that an individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married. This standard, taken from the alimony provision, § 71(a), is also used in connection with the status for personal exemptions, § 153, and the standard deduction, § 143, so as to produce uniformity. There is no "living together" requirement. If one spouse is a nonresident alien at any time during the year, a joint return may not be filed. § 6013(a)(1).

[3] Section 6013(a)(2).

[4] Section 6013(a)(3).

joint and several,[5] and adapts [the tax table] to use on a split-income basis by joint-return filers with adjusted gross income less than $5000.[6]

The Senate Report describes the method of computation in detail.[7] It indicates that since the filing of a joint return is elective, an election to file, and more important a failure to elect through filing a separate return, cannot be changed after the time for filing has expired.[°] The Report also elaborates on the rules applicable in the case of the death of a spouse.[8]

Note

1. Married couples will almost invariably file joint returns. Exceptions will occur when one of the spouses refuses to sign the return; when the income of the spouses is about equally divided and both have net capital losses (on a joint return, only $1,000 of ordinary income can be offset by capital losses; on separate returns, each spouse would have a $1,000 offset); and where both have about equal amounts of income and one has substantial medical expenses (since "adjusted gross income" will be smaller on the separate returns, more of the medical expenses can be deducted).

2. What *is* a joint return? This question is important not only because the benefits of income-splitting are available only if a joint return is filed, but also because both spouses become liable on a joint return for the tax and for fraud penalties if applicable. See *McCord* v. *Granger*, 201 F.2d 103 (3d Cir. 1952); *Manton* v. *Commissioner*, 11 T.C. 831 (1948). See also *Floyd Estate* (No. 2), 76 Pa. Dist. & Co. 597 (1951) (Orphans' Court, Delaware County, Pa.), reprinted in 51-4 P-H Federal Tax Service ¶ 72,559, ordering a co-executrix to sign a joint return in order to obtain the benefits of income-splitting for the estate of a deceased taxpayer with respect to income prior to his death.

3. Once the privilege of income-splitting was extended to couples in common law states, the "new" community property states lost their taste for Spanish law and repealed their statutes. See Note, Epilogue to the Community Property Scramble: Problems of Repeal, 50 *Col. L. Rev.* 332 (1950).

4. The 1954 Code permits a "surviving spouse" to file a joint return for two years after the death of his or her spouse, provided he or she has not remarried and maintains a home for a dependent child.

H. REPT. NO. 586, 82D CONG., 1ST SESS.

House Committee on Ways & Means, 1951

51–2 C.B. 357, 362–365

1. *Description*

The bill provides a new surtax table applicable, for taxable years beginning after August 31, 1951, to persons who qualify as a "head of household." . . . The new surtax table is constructed to give heads of households approximately one-half of the benefits of income splitting. The brackets and rates are adjusted so that it is unnecessary for persons using this table to divide their income by two and then multiply the tax by two as is presently required of married persons filing joint returns, who receive the full benefit of income splitting. . . .

[5] Section 6013(a)(4)(C).

[6] Section 3. The withholding system is now based entirely on the first bracket rate, thereby reflecting the split-income computation.

[7] Sen. Rep. No. 1013, pt. I at 52–54.

[°] This rule was changed by the 1951 Revenue Act. See § 6013(b). [Ed.]

[8] Sen. Rep. No. 1013, pt. I at 56–58.

3. *Reasons for adopting the head-of-household provision*

It is believed that taxpayers, not having spouses but nevertheless required to maintain a household for the benefit of other individuals, are in a somewhat similar position to married couples who, because they may share their income, are treated under present law substantially as if they were two single individuals each with half of the total income of the couple. The income of a head of household who must maintain a home for a child, for example, is likely to be shared with the child to the extent necessary to maintain the home, and raise and educate the child. This, it is believed, justifies the extension of some of the benefits of income splitting. The hardship appears particularly severe in the case of the individual with children to raise who, upon the death of his spouse, finds himself in the position not only of being denied the spouse's aid in raising the children, but under present law also may find his tax load heavier.*

However, it was not deemed appropriate to give a head of household the full benefits of income splitting because it appears unlikely that there is as much sharing of income in these cases as between spouses. In the case of savings, for example, it appears unlikely that this income will be shared by a widow or widower with his child to the same extent as in the case of spouses. As a result only one-half of the benefits of income splitting are granted to heads of households.

In defining the relationship to the taxpayer of an individual who enables the taxpayer to claim the head-of-household status, the relationships provided in section 25(b)(3) of the Code for claiming a dependency credit have been followed. In all cases except those in which unmarried children, stepchildren, and their descendants share the household the taxpayer must supply over half of the support of the individual and the individual must have gross income of less than $500.† These limitations are deemed desirable to prevent abuse of the head-of-household status. However, they are not believed necessary in the close relationships existing in the case of children, stepchildren, or their descendants, in view of the requirement that such individuals must live in the same household as the taxpayer, except for the temporary absences previously described, and the requirement that the taxpayer must supply over half the cost of maintaining the household. However, these limitations are applied where the children or grandchildren are married. This will prevent extending the benefits of a head of household to a parent while the child is himself obtaining the benefits of income splitting with his spouse.

Note

The Senate took the position that the head of a household should be granted only 25 per cent of the benefits of income-splitting, pointing out that the taxpayer was not required to include the income of minor children in his return. S. Rept. No. 781, 82d Cong., 1st sess, 51-2 C.B. 458, 464. But the House view carried.

In 1954, the House proposed to extend to heads of households the same income-splitting benefits that are provided for married couples. The Senate refused to accept this change, and the House receded. The 1954 Code expands the definition of a head of a household to include a taxpayer who maintains a household for his father or

* See paragraph (4), Note, p. 289. [Ed.]

† Now $600. [Ed.]

mother, even though it is separate from his own household. Previously the parent would confer head of household status on the taxpayer only if they lived together.

The effects of income-splitting for married couples and heads of households, taken in conjunction with the standard deduction and the personal exemptions, may be seen in the table that follows

COMPARATIVE TAX BURDENS—SINGLE PERSONS, HEADS OF HOUSEHOLDS, MARRIED COUPLES
(1954 Rates)

	SINGLE PERSON		HEAD OF HOUSEHOLD, ONE DEPENDENT		MARRIED COUPLE, NO DEPENDENTS		HEAD OF HOUSEHOLD, TWO DEPENDENTS		MARRIED COUPLE, TWO DEPENDENTS	
Adjusted gross income	*Taxable income*[1]	*Tax*	*Taxable income*[1]	*Tax*	*Taxable income*[1]	*Tax*	*Taxable income*[1]	*Tax*	*Taxable income*[1]	*Tax*
$ 2,500	$ 1,650	$ 330	$ 1,050	$ 210	$ 1,050	$ 210	$ 450	$ 90	0	0
5,000	3,900	818	3,300	673	3,300	660	2,700	547	$ 2,100	$ 420
10,000	8,400	2,096	7,800	1,768	7,800	1,636	7,200	1,612	6,600	1,372
25,000	23,400	9,206	22,800	7,592	22,800	6,244	22,200	7,294	21,600	5,888
50,000	48,400	25,668	47,800	22,128	47,800	19,002	47,200	21,732	46,600	18,294
100,000	98,400	65,928	97,800	58,720	97,800	52,056	97,200	58,240	96,600	51,192

[1] Taxable income Adjusted gross income less standard deduction and exemptions.

THE TAX TREATMENT OF FAMILY INCOME

Division of Tax Research, Treasury Department, 1947
pp. i, 4-7

This study examines alternative procedures for reducing tax differences which result from the present treatment of family income under the individual income tax. Present law * discriminates between families on the basis of residence, by enabling couples in community-property States to divide their earned and investment community income between separate tax returns thereby reducing their taxes through the double use of the lower rates of the progressive tax rate schedule. It discriminates also on the basis of the nature of income, by requiring earned income in noncommunity-property States to be taxed to the earner, but affording recipients of investment income numerous opportunities for splitting that income with members of their family. Finally, it discriminates between recipients of investment income by favoring families who avail themselves of opportunities to split income by gift and such devices as family trusts, corporations, and partnerships. . . .

Proposals for the elimination of the inequities inherent in the tax differences resulting from the present tax treatment of family income under the individual income tax have been considered by the Congress on several occasions in the past. These proposals reflect the different points of view from which the problem can be approached.

At one extreme is the doctrine that taxpaying ability is determined by total family income regardless of the distribution of the ownership of such income among the members of the family. Those holding this view propose that the family's total income be taxed as a unit in order that families with equal incomes

* 1947 — *i.e.*, before adoption of income-splitting by the Revenue Act of 1948. [Ed.]

and equal exemptions be subjected to equal taxes. They would require that all married couples having the same amount of net income pay the same amount of tax, regardless of whether husband or wife is the income receiver or whether both contribute to the family income in varying proportions. One procedure for giving effect to this theory is to make joint returns mandatory. to apply the graduated rates of the individual income tax against the combined income of the spouses, after requiring them to file a joint return. An alternative procedure is to continue to give married couples the option of filing joint or separate returns, but to require those filing separate returns to use a new rate schedule employing smaller brackets which would in effect take the profit out of separate returns and tend to equalize the tax on all married couples with equal incomes. Another alternative, which has recently received considerable attention and therefore is treated in this memorandum at some length, is to tax each spouse on one-half of the couple's combined income, giving each the benefits of lower rates in the graduated surtax schedule.

Another approach to this problem and one which is diametrically opposed to any of the aforementioned procedures for the handling of family income proceeds from the assumption that the family as a unit has no combined taxpaying ability *per se;* that its taxpaying ability is composed of the separate taxpaying abilities of its individual members; and that the taxpaying ability of each of these is determined by the amount of income of which he or she is the owner without reference to the income of the other members of the family. This approach sanctions the tax effects of income-splitting within the family provided that the transferer actually parts with title to and control of the property. This, in substance, is the rationale underlying the present income tax practice which accords each spouse the privilege of filing a separate return covering only his or her separate income. However, even those who favor basing taxes on individual legal rights to income, differ on its specific application. The large volume of litigation involving the recognition for tax purposes of income-splitting by means of trusts, assignments, etc., attests to the differences in opinion as to the degree of separation of ownership and control needed before the tax reduction effects of income-splitting can be accepted. Some deny that the differences in the matter of title to income between the community-property systems are sufficiently real to justify the present differentiation in the tax treatment of married couples with the same combined incomes. They therefore propose to tax personal-service income to the earner and to tax income derived from community-property to the spouse exercising management and control. This approach is an attempt to reconcile the tax effects of automatic division of community income practiced in community-property States with the situation in noncommunity-property States when property and control are actually transferred from one spouse to the other.

The issue involved in these alternatives—basing tax liabilities on total family income vs. basing them on individual legal rights to income—relates primarily to the choice of the basic tax units under the individual income tax. Since the identification of the taxpayer unit under present law is unsatisfactory to many taxpayers, the objective is to find an alternative method of identifying the taxpayer unit which will be better fitted to the application of the doctrine that taxpayers equally situated as to income and size of family should pay equal taxes. However, when this issue is resolved, there still remains the problem of determining the

taxpaying abilities of single persons and families of varying size, all with equal incomes.

It is generally agreed that the relative taxpaying abilities of families of different size cannot be determined merely with reference to their incomes. In practice this requires an adjustment for size of family to provide equitable relative tax loads on equal-income families of varying size. The present income tax [1947] resolves this problem by assuming that the uniform per capita exemption allowed for each member of the family, regardless of their number, is adequate adjustment for size of family, and that income remaining after such adjustment is homogeneous in all respects except as to size of income. It, therefore, applies to this homogeneous income one rate schedule which relates taxpaying ability to size of income. At the lower levels of income (those falling entirely within the first surtax bracket), present law imposes on married couples twice the tax paid by single persons with half their income. At the upper income levels it imposes on married couples filing joint returns (and also on those filing separate returns covering substantially unequal incomes) more than twice the tax paid by single persons with half their income, whereas married couples reporting equal incomes on separate returns pay twice the tax incurred by a single person with one-half the income.

The information now available does not cast adequate light on the problem of the relative taxpaying abilities of families of varying size at all income levels. One criterion would be to impose relative tax burdens in accordance with ratios indicated by the relative incomes needed by families of different size to obtain the same standard of living. Although the available information respecting standards of living by size of family is at best fragmentary and representative only of the lower income families, it indicates, for example, that a single person living alone needs about two-thirds the money income of a married couple to maintain the same standard of living; and that a married couple with two dependents needs only about 50 percent more money income than one without dependents and only somewhat more than twice the money income of a single person to attain the same standard of living.

The use of these ratios for the purpose of appraising alternative methods of solving the family income problem is subject to several important limitations. It appears, for example, that a married couple does not need twice the money income of a single person to attain the same standard of living because the housewife contributes a substantial amount of real income to the family. However, the income tax applies largely to money incomes and not real incomes. The determination of the relative taxpaying abilities in accordance with the above-indicated ratios would seem to involve the taxation of the real income added by the housewife. Another limitation stems from the fact already mentioned that the data used to obtain the above relative income ratios pertain to relatively low-income groups (primarily under $5,000), whereas the family income problem under consideration pertains primarily to middle-and upper-income groups. Finally, the proportion of income used for consumption purposes tends to decrease and savings tend to increase as income increases. Thus, the ratios of relative income needed to obtain comparable levels of living would have less and less applicability, as an index of relative taxpaying abilities, as a larger and larger proportion of income is saved.

The quantitative information on the effects of a change in the size of families on taxpaying ability is incomplete and provides little basis for choosing among the alternative methods of treating family income for tax purposes. . . .

INDIVIDUAL INCOME TAX EXEMPTIONS

Division of Tax Research, Treasury Department, 1947
pp. i, v–vi, viii

1. *Wartime reduction in exemptions*

One of the most striking features of the war finance program was the reduction in personal exemptions under the individual income tax. At the low point reached under the Individual Income Tax Act of 1944, all persons with net income above a flat $500 exemption were subject to normal tax. Under present law [1947] the taxpayer is allowed an exemption of $500 each, for himself, his wife, and dependents for both normal tax and surtax. . . .

Taking the exemptions which prevailed in the income year 1939 as a basis of comparison, the present exemption, without adjustment for price changes, is 50 per cent of the 1939 figure in the case of single individuals, 40 per cent for married couples, and 125 per cent for dependents. The net result of exemption revisions since 1939 has been a sharp decrease in exemptions for single persons and married couples, but a substantial increase in the dependent exemption.

2. *Exemptions and the increase in living costs*

To appreciate fully the extent of the wartime reduction in exemption levels it is necessary to take into account not merely the dollar decrease in exemptions but the even greater decrease in the value of the exemptions when expressed in terms of goods and services. The rise in the cost of living has sharply reduced the command of the dollar exemptions over goods and services. While this development may have imposed income tax at real income levels not necessarily intended when the present exemptions were adopted, it is in accord with the view of those who held that the income tax base should have been further broadened. . . . The amount to which a $500 exemption would have to be adjusted upward merely to offset the effect of price increases since 1939, 1942 and 1944 is indicated [chart omitted] as being $824, $703, and $653, respectively. This chart also compares present exemptions with 1939 exemptions adjusted upward to provide the same purchasing power as in 1939. Thus, 1939 exemptions for single persons, married couples, and dependents had the same purchasing power, respectively, as $1,648, $4,120 and $659 had in September 1947.

3. *Specific problems and issues*

The individual income tax exemptions are related to the role of the individual income tax in the revenue system as a whole and its overall strength. In addition to the basic policy questions involved in determining over-all revenue goals and the relative emphasis on individual, business, and excise tax sources, the question of exemption revision raises the following more specific issues:

(a) The question of an immediate adjustment of the exemptions to take account of higher living costs,

(b) the postwar level of exemptions consistent with adequate revenues and the extent of reliance on the individual income tax as compared with other taxes,
(c) the choice between rate and exemption adjustments,
(d) the question of the relative amounts of exemption for single persons, married couples, and dependents, and,
(e) the timing of exemption changes in relation to economic and fiscal conditions.

Other questions which may call for consideration include (1) the possibility of a substitute for higher exemptions, such as a special low starting rate or special deductions for hardship cases, (2) proposals for a basic change in exemption method, involving the adoption of tax credits or other devices in lieu of exemptions; and (3) stability versus flexibility of exemptions in the postwar tax structure.

4. *Exemptions compared with family budgets*

In legislative and other discussions of income tax exemptions, reference is generally made to the objective of relieving some minimum standard of living from direct tax. Concepts of such a minimum standard differ, ranging from a bare subsistence to a comfortable standard of life. From the standpoint of sound social policy, it has been held that an income tax exemption below the maintenance budget requirements of a manual worker and his family is undesirable because it would tend to result in lower economic vitality, less production, and possibly higher Government expenditures for social purposes.

In [the table below], existing exemptions are compared with the latest information (September 1947) available for a maintenance budget level, a modest but currently adequate standard of living for a city worker's family, and a so-called health and decency budget level. These comparisons indicate that present exemp-

PRESENT EXEMPTIONS COMPARED WITH ESTIMATED FAMILY BUDGET LEVELS
(Sept 1947 Prices)

	1947 Gross Exemptions [1]	ESTIMATED BUDGET LEVELS [2]		
		Maintenance	City Worker's Budget [3]	Health and Decency
Single Person	$ 550	$ 955	$1,495	$1,686
Married Couple	1,125	1,364	2,136	2,408
Married Couple, Two Dependents	2,225	2,080	3,257	3,672

[1] Minimum level of adjusted gross income subject to tax under 1946 Form 1040 tax table. (1954 equivalents, see tax table in Section 3, 1954 Code, are $675, $1,325, and $2,675. [Ed.])
[2] Exclusive of Federal income tax and adjusted to Sept 1947 prices on the basis of B L S consumers' price index (The B L S index stood at 163 8 in Sept 1947. It had risen to 192.3 by May 1954. Monthly Labor Review, Vol. 65, No. 6 (1947), Vol. 77, No. 7 (1954). [Ed.])
[3] A modest but currently adequate budget for a city worker's family.

tions are substantially below maintenance requirements for a single individual with no dependents, and for a married couple with no dependents. However, the present $500 dependent exemption apparently exceeds the maintenance requirements for a dependent, so that present exemptions are perhaps within the range of adequacy for married couples with one or two dependents and are more than adequate to cover a maintenance standard for a married couple with more than two dependents. Present exemption levels are substantially below the requirements for the other two higher levels of living for all family sizes.

Family budget data are also useful in throwing light on the question of what relative amounts of exemption should be allowed for single persons, married couples, and dependents, as distinguished from the issue of the dollar amounts or the general level of exemptions. On the basis of the available information with respect to comparable living requirements for different-sized families, summarized in the following table, the [1947] per capita exemption appears to allow relatively too little exemption for single individuals living alone, and relatively too much for dependents, taking the married couple with no dependents as the standard of reference.

PRESENT EXEMPTIONS COMPARED WITH BUREAU OF LABOR STATISTICS ESTIMATES OF INCOMES NEEDED TO ACHIEVE COMPARABLE LEVELS OF LIVING
(Relatives: married couple, no dependents = 100)

Exemption	Bureau of Labor Statistics estimates	Exemptions for single persons, married couples and dependents, respectively, of		
		$ 500, 1,000, 500	$ 800, 1,600, 400	$ 800, 1,200 400
Single, no dependents	70.0	50	50	67
Married, no dependents	100.0	100	100	100
Married, 1 dependent	128.0	150	125	133
Married, 2 dependents	152.5	200	150	167
Married, 3 dependents	174.0	250	175	200
Married, 4 dependents	194.5	300	200	233

5. *Revenue, number of taxpayers, and tax base*

As shown [chart omitted] exemption changes exert a powerful leverage on individual income tax revenue, tax base, and taxpayers. According to estimates assuming $166 billion of national income payments in 1947, on which [the chart] is based, an increase in the exemption from $500 to $600 per capita would reduce (a) individual income tax revenue by about $1.6 billion or almost 10 per cent, (b) the number of individual income taxpayers by about 5 million or almost 10 per cent, and (c) the surtax net income base by about $8 billion or 12 per cent, as compared with present law.

On the same assumptions, an increase in exemptions from $500 to $700 per capita would decrease (a) individual income tax revenue by about $3 billion or 18 per cent, (b) the number of individual income taxpayers by about 11 million or 22 per cent, and (c) the surtax net income base by $15 billion or 22 per cent.*

Section C. Income-Splitting By Private Arrangement

Before 1948, when Congress granted to married couples the privilege of splitting their income for tax purposes by filing joint returns, every conceivable method of accomplishing the same result by private arrangement was essayed by taxpayers. The materials that follow illustrate the most popular of these plans and the judicial, administrative, and legislative responses that they evoked.

* In 1954 the Treasury estimated that, at current levels, an increase in the per capita exemptions of $100 would result in a revenue loss of $2 4 billion and that an increase of $200 would result in a revenue loss of $4.5 billion. To recoup this loss by a proportional increase in all tax rates, increases of 9 per cent and 19 per cent respectively would be required. Alternatively, all income (after exemptions and deductions) above $19,000 ($38,000 on joint returns) or $11,000

Although the pressure to devise a private arrangement for income-splitting was greatly reduced when Congress enacted the income-splitting provision of 1948 and the head-of-household provision of 1951, tax advantages can still be enjoyed if income can be split with children or others. The greater the number of individuals among whom a given amount of income can be divided, the greater the tax savings. Moreover, the optional standard deduction may lend additional enchantment to income-splitting. Thus, a married couple with two dependents is entitled to a maximum optional standard deduction of $1000 on a joint return; if income is divided so that husband and wife file a joint return and the two dependents each file a separate return, the aggregate standard deduction may rise to $3000. The amount of tax that may be saved by a married couple with two dependents by splitting various amounts of adjusted gross income equally among all members of the family is shown by this table:

EFFECT OF INCOME-SPLITTING—1954 RATES

ADJUSTED GROSS INCOME	MARRIED COUPLE WITH 2 DEPENDENTS			
	Income on joint return		Income split—3 or 4 returns[2]	
	Taxable income[1]	*Tax*	*Taxable income*[1]	*Tax*
$ 10,000	$ 6,600	$ 1,372	$ 6,600	$ 1,320
25,000	21,000	5,888	20,350[3]	4,491
50,000	46,600	18,294	44,600[4]	12,208
100,000	96,600	51,192	94,600[5]	37,414
250,000	246,600	176,114	244,600[6]	140,868

[1] Taxable income· adjusted gross income less optional standard deduction and exemptions

[2] Result would be the same where income is split equally among four members of family whether husband and wife file separate returns (making 4 returns in all) or joint return (3 returns in all)

[3] Husband and wife, $5150 each; dependents, $5025 each. The disparity results from § 141's limitation of the standard deduction to $500 in the case of a married person filing a separate return, if a joint return were filed instead, the $1000 ceiling on the standard deduction would have the same effect A slight tax savings could be effected by splitting the income so as to give the dependents a little more than the husband and wife.

[4] Husband and wife, $11,400 each, dependents, $10,900 each.

[5] Husband and wife, $23,900 each, dependents, $23,400 each

[6] Husband and wife $61,400 each; dependents, $60,900 each.

Somewhat less important areas in which intra-family income-splitting remains a lively subject include pre-1948 returns, which will continue in dispute and litigation for some years; taxpayers who have dependent relatives but who are not entitled to the head-of-household privilege, and married taxpayers who do not wish to have their returns signed by their spouses, as is required for joint returns.

Beyond all this, however, the impact of thirty years' of income-splitting tactics upon the law of federal income taxation is incalculable. The judicial doctrines worked out during this period have penetrated to every crevice of our tax structure, so that the relationships of employer and employee, of parent corporation and subsidiary, of corporation and stockholder, of philanthropist and charity, and of landlord and tenant are all influenced by the cases that follow.

($22,000 on joint returns) respectively would have to be confiscated to recoup the revenue loss. Hearings on Internal Revenue Code of 1954, Senate Finance Committee, 83d Cong., 2d sess., Part 1, p. 139. [Ed.]

1. Gifts

LUCAS v. EARL

Supreme Court of the U. S., 1930
281 U.S. 111

MR. JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the Circuit Court of Appeals, 30 F.(2d) 898. A writ of certiorari was granted by this court.

By the contract, made in 1901, Earl and his wife agreed

> that any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the State of California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 . . . imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid," § 213(a). . .* A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

THE CHIEF JUSTICE took no part in this case.

* Now § 61. [Ed.]

Note

1. Was Mrs. Earl also taxable on the income in question?

2. Suppose Mrs. Earl, or a third party, had paid for Mr. Earl's legal education, his law library, etc. in return for an assignment of 50 per cent of his professional earnings either for a stated period or for life. Would the income then be taxed to Mr. Earl?

G.C.M. 27026

Bureau of Internal Revenue, 1951
51-2 C.B. 7

An opinion is requested as to the treatment for Federal income tax purposes of the proceeds derived from public entertainments conducted for the benefit of charitable organizations.

It is a common practice for those engaged in the business of promoting sporting events, or other forms of public entertainment, to designate events conducted on certain days as "charity" events, the net proceeds being turned over to specific charitable organizations.

It is a well-established principle, based on decisions of the Supreme Court of the United States, that an assignment of income by the person who earns it, or is otherwise entitled to it, does not relieve him from tax on such income. When a person who is in the business of promoting sporting events, or other public entertainments, enters into an agreement with a charitable organization under the terms of which the facilities of the former are operated by him as agent for the charitable organization, and all the proceeds from the event less expenses are received by or on account of the latter, the promoter is in effect assigning to the charitable organization earnings derived by him from the operation of the event. To allow the promoter in these circumstances to exclude such amounts from his gross income would be to give effect to form rather than substance, and would permit circumvention of the specific statutory limitations, contained in section 23(o) and (q) of the Internal Revenue Code,* on the amount of charitable contributions which is deductible in computing net income. This office is accordingly of the opinion that if a professional promoter would, in the absence of an agreement between the parties, be entitled to the proceeds of an event, such agreement will not operate to permit him to exclude the proceeds of the event from his income for Federal income tax purposes.

It is recognized, however, that there are instances in which a charitable organization is itself the promoter of an event designed to produce income to be used for its purposes. Bazaars, amateur productions, and sporting events are, of course, frequently promoted by such organizations. If the charitable organization is actually the promoter of an event, the fact that services and property are contributed or facilities loaned to the organization does not, of itself, result in tax to the contributor or lender.

Determination of whether the charitable organization is in substance the beneficiary of profits earned by a professional promoter of an event, or whether it is itself the promoter, must depend on the particular facts in each case, considering the realities of the situation.

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* Now § 170. [Ed.]

Note

1. Note what Mr. Justice Holmes said of "attenuated subtleties" in *Lucas* v. *Earl*, *supra*. How would you conduct negotiations on behalf of a promoter to avoid imputation of the income to him?

2. Is the principle set out above applicable only to promoters, or does it embrace all performers? See Regs. 118, Sec. 39.22(a)-2(c). A few years before this regulation was issued there was a spirited exchange between Assistant Attorney General (now Mr. Justice) Jackson and several members of a joint Congressional committee over a Treasury ruling that the proceeds of Mrs. Roosevelt's radio broadcasts, which were paid to charities, were not taxable to her. The basis of the ruling was thus stated by Mr. Jackson:

> One who earns a salary or wages or has income from invested property cannot assign that income nor order it to be paid to a person or corporation so as to avoid a tax merely by routing his income so as not to pass through his hands. But this doctrine of constructive receipt of income cannot be used to create income when there is no income, and has never been used to justify a tax on services devoted to charity. Mrs. Roosevelt declined to work for money and was only willing to serve for charity's sake. It was and is my opinion that such benefit broadcasts do not result in taxable income. (Hearings before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st sess., Part 4, 426(1937).)

Are similar practices prevented by the subsequently-issued regulation cited above? See Rev. Rul. 71, 53-1 C.B. 18.

3. See § 114, added in 1952.

BLAIR v. COMMISSIONER

Supreme Court of the U. S., 1937
300 U.S. 5

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

This case presents the question of liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the tax years and which the trustees had paid to them accordingly.

The trust was created by the will of William Blair, a resident of Illinois who died in 1899, and was of property located in that State. One-half of the net income was to be paid to the donor's widow during her life. His son, the petitioner Edward Tyler Blair, was to receive the other one-half and, after the death of the widow, the whole of the net income during his life. In 1923, after the widow's death, petitioner assigned to his daughter, Lucy Blair Linn, an interest amounting to $6,000 for the remainder of that calendar year, and to $9,000 in each calendar year thereafter, in the net income which the petitioner was then or might thereafter be entitled to receive during his life. At about the same time, he made like assignments of interest, amounting to $9,000 in each calendar year, in the net income of the trust to his daughter Edith Blair and to his son, Edward Seymour Blair, respectively. In later years, by similar instruments, he assigned to these children additional interests, and to his son William McCormick Blair other specified interests in the net income. The trustees accepted the assignments and distributed the income directly to the assignees.

[After holding that a judgment in an earlier proceeding involving the same trust was not conclusive in this proceeding as res judicata and that the assign-

ments were valid under local law, the Supreme Court turned to the third issue in the case.]

Third. The question remains whether, treating the assignments as valid, the assignor was still taxable upon the income under the federal income tax act. That is a federal question.

Our decisions in *Lucas* v. *Earl,* 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731, and *Burnet* v. *Leininger,* 285 U.S. 136, 52 S. Ct. 345, 76 L. Ed. 665, are cited. In the *Lucas* Case the question was whether an attorney was taxable for the whole of his salary and fees earned by him in the tax years or only upon one-half by reason of an agreement with his wife by which his earnings were to be received and owned by them jointly. We were of the opinion that the case turned upon the construction of the taxing act. We said that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." That was deemed to be the meaning of the statute as to compensation for personal service and the one who earned the income was held to be subject to the tax. In *Burnet* v. *Leininger, supra,* a husband, a member of a firm, assigned future partnership income to his wife. We found that the revenue act dealt explicitly with the liability of partners as such. The wife did not become a member of the firm, the act specifically taxed the distributive share of each partner in the net income of the firm, and the husband by the fair import of the act remained taxable upon his distributive share. These cases are not in point. The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation. . . . There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer's retention of control. *Corliss* v. *Bowers,* 281 U.S. 376, 50 S. Ct. 336, 74 L. Ed. 916, *Burnet* v. *Guggenheim,* 288 U.S. 280, 53 S. Ct 369, 77 L. Ed. 748.

In the instant case, the tax is upon income as to which, in the general application of the revenue acts, the tax liability attaches to ownership. See *Poe* v. *Seaborn, supra; Hoeper* v. *Tax Commission,* 284 U.S. 206, 52 S. Ct. 120, 76 L. Ed. 248.

The Government points to the provisions of the revenue acts imposing upon the beneficiary of a trust the liability for the tax upon the income distributable to the beneficiary. But the term is merely descriptive of the one entitled to the beneficial interest. These provisions cannot be taken to preclude valid assignments of the beneficial interest, or to affect the duty of the trustee to distribute income to the owner of the beneficial interest, whether he was such initially or becomes such by valid assignment. The one who is to receive the income as the owner of the beneficial interest is to pay the tax. If under the law governing the trust the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary and is entitled to rights and remedies accordingly. We find nothing in the revenue acts which denies him that status.

The decision of the Circuit Court of Appeals turned upon the effect to be ascribed to the assignments. The court held that the petitioner had no interest in the corpus of the estate and could not dispose of the income until he received it.

Hence it was said that "the income was *his*" and his assignment was merely a direction to pay over to others what was due to himself. The question was considered to involve "the date when the income became transferable." 83 F.(2d) 655, at page 662. The Government refers to the terms of the assignment—that it was of the interest in the income "which the said party of the first part now is, or may hereafter be, entitled to receive during his life from the trustees." From this it is urged that the assignments "dealt only with a right to receive the income" and that "no attempt was made to assign any equitable right, title or interest in the trust itself." This construction seems to us to be a strained one. We think it apparent that the conveyancer was not seeking to limit the assignment so as to make it anything less than a complete transfer of the specified interest of the petitioner as the life beneficiary of the trust, but that with ample caution he was using words to effect such a transfer. That the state court so construed the assignments appears from the final decree which described them as voluntary assignments of interests of the petitioner "in said trust estate," and it was in that aspect that petitioner's right to make the assignments was sustained.

The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property. . . . By virtue of that interest he was entitled to enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. . . . The beneficiary may thus transfer a part of his interest as well as the whole. See Restatement of the Law of Trusts, §§ 130, 132 *et seq.* The assignment of the beneficial interest is not the assignment of a chose in action but of the "right, title, and estate in and to property." . . . See Bogert, *Trusts and Trustees*, vol. 1, § 183, pp. 516, 517; 17 *Columbia Law Review*, 269, 273, 289, 290.

We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income, and that as to these interests they and not the petitioner were taxable for the tax years in question. The judgment of the Circuit Court of Appeals is reversed and the cause is remanded with direction to affirm the decision of the Board of Tax Appeals.

It is so ordered.

HELVERING v. HORST

Supreme Court of the U. S., 1940

311 U.S. 112

MR. JUSTICE STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935 respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that under the applicable § 22 of the Revenue Act of 1934, 48 Stat.

680, 686, 26 U.S.C.A. Int. Rev. Acts, page 669, the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. 2 Cir., 107 F.2d 906; 39 B.T.A. 757. We granted certiorari, 309 U.S. 650, 60 S. Ct. 807, 84 L. Ed. 1001, because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731, and with that of decisions by other circuit courts of appeals. See *Bishop* v. *Commissioner*, 7 Cir., 54 F.2d 298; *Dickey* v. *Burnet*, 8 Cir., 56 F.2d 917, 921; *Van Meter* v. *Commissioner*, 8 Cir., 61 F.2d 817.

The court below thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from *Lucas* v. *Earl*, *supra* and *Burnet* v. *Leininger*, 285 U.S. 136, 52 S. Ct. 345, 76 L. Ed. 665, where the assignment of compensation for services had preceded the rendition of the services, and where the income was held taxable to the donor.

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 49 S. Ct. 499, 73 L. Ed. 918, *Corliss* v. *Bowers*, 281 U.S. 376, 378, 50 S. Ct. 336, 74 L. Ed. 916, *Cf. Burnet* v. *Wells*, 289 U.S. 670, 53 S. Ct. 761, 77 L. Ed. 1439.

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment

is consummated by some event other than the taxpayer's personal receipt of money or property. *Cf. Aluminum Castings Co.* v. *Routzahn,* 282 U.S. 92, 98, 51 S. Ct. 11, 13, 75 L. Ed. 234. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see *Old Colony Trust Co.* v. *Commissioner, supra; Bowers* v. *Kerbaugh-Empire Co.,* 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886; *United States* v. *Kirby Lumber Co.,* 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131, or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167, Revenue Act of 1934, 26 U.S.C.A. Int. Rev. Code, §§ 166, 167, *Corliss* v. *Bowers, supra; cf. Dickey* v. *Burnet,* 8 Cir., 56 F.2d 917, 921, he does not escape taxation because he did not actually receive the money. *Cf. Douglas* v. *Willcuts,* 296 U.S. 1, 56 S. Ct. 59, 80 L. Ed. 3, 101 A.L.R. 391; *Helvering* v. *Clifford,* 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788.

Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. *Cf. Burnet* v. *Wells, supra.*

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named. *Burnet* v. *Wells, supra.*

In a real sense he has enjoyed compensation for money loaned or services rendered and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of

common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, *Lucas* v. *Earl*, *supra; Burnet* v. *Leininger*, *supra*, for it was recognized in the *Leininger* case that in such a case the rendition of the service by the assignor was the means by which the income was controlled by the donor and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment and in both cases it is the exercise of the power of disposition of the interest or compensation with the resulting payment to the donee which is the enjoyment by the donor of income derived from them.

This was emphasized in *Blair* v. *Commissioner*, 300 U.S. 5, 57 S. Ct. 330, 81 L. Ed. 465, on which respondent relies, where the distinction was taken between a gift of income derived from an obligation to pay compensation and a gift of income-producing property. In the circumstances of that case the right to income from the trust property was thought to be so identified with the equitable ownership of the property from which alone the beneficiary derived his right to receive the income and his power to command disposition of it that a gift of the income by the beneficiary became effective only as a gift of his ownership of the property producing it. Since the gift was deemed to be a gift of the property the income from it was held to be the income of the owner of the property, who was the donee, not the donor, a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm has been given away. *Blair* v. *Commissioner*, *supra*, 300 U.S. 12, 13, 57 S. Ct. 333, 81 L. Ed. 465 and cases cited. See also *Reinecke* v. *Smith*, 289, U.S. 172, 177, 53 S. Ct. 570, 572, 77 L. Ed. 1109. We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee. *Corliss* v. *Bowers*, *supra*. *Cf. Helvering* v. *Clifford*, *supra*.

The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, *Corliss* v. *Bowers*, *supra*, 281 U.S. 378, 50 S. Ct. 336, 74 L. Ed. 916; *Burnet* v. *Guggenheim*, 288 U.S. 280, 283, 53, S. Ct. 369, 370, 77 L. Ed. 748. The tax laid by the 1934 Revenue Act upon income "derived from . . . wages, or compensation for personal service, of whatever kind and in whatever form paid . . . ; also from interest . . . " therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

It is the statute which taxes the income to the donor although paid to his donee. *Lucas* v. *Earl*, *supra; Burnet* v. *Leininger*, *supra*. True, in those cases the service which created the right to income followed the assignment and it was arguable that in point of legal theory the right to the compensation vested instantaneously

in the assignor when paid although he never received it; while here the right of the assignor to receive the income antedated the assignment which transferred the right and thus precluded such an instantaneous vesting. But the statute affords no basis for such "attenuated subtleties." The distinction was explicitly rejected as the basis of decision in *Lucas* v. *Earl.* It should be rejected here, for no more than in the *Earl* case can the purpose of the statute to tax the income to him who earns, or creates and enjoys it be escaped by "anticipatory arrangements . . . however skilfully devised" to prevent the income from vesting even for a second in the donor.

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. See *Lucas* v. *Earl, supra,* 281 U.S. 115, 50 S. Ct. 241, 74 L. Ed. 731.

Reversed.

The separate opinion of MR. JUSTICE MCREYNOLDS.

The facts were stipulated. In the opinion of the court below [107 F.2d 907], the issues are thus adequately stated:

> The petitioner owned a number of coupon bonds. The coupons represented the interest on the bonds and were payable to bearer. In 1934 he detached unmatured coupons of face value of $25,182.50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, $25,182.50, as his own property. There was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year. The Board of Tax Appeals, three members dissenting, sustained the Commissioner, holding that the amounts collected on the coupons were taxable as income to the petitioner.

The decision of the Board of Tax Appeals was reversed and properly so, I think.

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

Neither *Lucas* v. *Earl,* 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731, nor *Burnet* v. *Leininger,* 285 U.S. 136, 52 S. Ct. 345, 76 L. Ed. 665, support petitioner's view. *Blair* v. *Commissioner,* 300 U.S. 5, 11, 12, 57 S. Ct. 330, 332, 333, 81 L. Ed. 465, shows that neither involved an unrestricted completed transfer of property.

Helvering v. *Clifford,* 309 U.S. 331, 335, 336, 60 S. Ct. 554, 556, 557, 84 L. Ed. 788, decided after the opinion below, is much relied upon by petitioner, but involved facts very different from those now before us. There no separate thing was absolutely transferred and put beyond possible control by the transferror,

The court affirmed that Clifford, both conveyor and trustee, "retained the substance of full enjoyment of all the rights which previously he had in the property." "In substance his control over the corpus was in all essential respects the same after the trust was created, as before." "With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before."

The general principles approved in *Blair* v. *Commissioner*, 300 U.S. 5, 57 S. Ct. 330, 81 L. Ed. 465, are applicable and controlling. The challenged judgment should be affirmed.

THE CHIEF JUSTICE and MR. JUSTICE ROBERTS concur in this opinion.

Note

1. One commentator has argued that a basis of the decision was that the gift was incomplete on the ground that the father could—up to the time the coupon became due and was presented for payment by the son or his assignee—have revoked by instructing the obligor of the bond to pay the interest to him and not to the holder of the coupon. See Miller, "Gifts of Income and of Property: What the Horst Case Decides," 5 *Tax L. Rev.* 1 (1949). Is this suggestion persuasive to you? In the Court of Appeals opinion in the *Horst* Case, 107 F.2d 906, 907, Judge Patterson said:

> The petitioner could not interfere in any way with the donee's control and right to receive the money when the coupons matured. . . . Generally liability to income tax attaches to ownership of the income, *Blair* v. *Commissioner*, 300 U.S. 5, 59 S. Ct. 530, 81 L. Ed. 465, and we see nothing to take the case out of the general rule. The case is not one where the assignor had power over the income after the assignment, as in *Corliss* v. *Bowers*, 281 U.S. 376, 50 S. Ct. 336, 74 L. Ed. 916. (107 F.2d 906, 907 (2d Cir. 1939)).

2. Was the father taxed on the value of the coupons at the time of gift or on the full amount of the interest? What if the interest had been paid in the year after the gift? Was it crucial to the decision that the father retained the bond? If so, why? What if he had given the coupon to his son and the bond to his daughter?

3. If the father, retaining the bond, had given all the interest coupons to his son, would the income be taxable to him? Compare the *Blair* case, *supra*, with *Harrison* v. *Schaffner*, 312 U.S. 579 (1941).

STRAUSS v. COMMISSIONER

U S. Court of Appeals, Second Circuit, 1948
168 F.2d 441, cert. den. 335 U.S. 858, reh den. 335 U.S. 888 (1948)

Before AUGUSTUS N. HAND, CHASE and FRANK, Circuit Judges.

CHASE, Circuit Judge.

The inventors of a process known as "Kodachrome," which is used in the manufacture of colored film, became entitled under a licensing agreement to receive royalties from the Eastman Kodak Company. On November 1, 1930, they assigned those royalties, except certain so-called flat royalties which may now be disregarded, to Kuhn, Loeb & Company as trustee to collect and pay them to those having the right to receive them.

The taxpayer was, on December 20, 1935, one of those who had a right to receive a certain percentage of such royalties from the trustee. He had acquired that right by performing certain personal services in connection with the financing

of the Kodachrome process. On December 20, 1935, the petitioner assigned all his "right, title and interest in Kodachrome, manufactured by the Eastman Kodak Company," to his wife and the trustee was duly advised that he had done so. During 1938, the trustee paid $10,209.50 to the taxpayer's wife and during 1939 $14,183.94 which would, but for the assignment to her, have been paid to the taxpayer as his share of the royalties. The wife reported such payments in the respective years they were received and paid income taxes thereon. The commissioner, holding that the assignment was of future payments to the taxpayer for personal services performed by him, included them in his gross income for the proper years and determined deficiencies accordingly. The taxpayer then petitioned the Tax Court to redetermine the deficiences, alleging, among other things, that in 1935 he was "the owner of an interest in the Kodachrome process of manufacturing color film." This was admitted in the respondent's answer and the Tax Court, three judges dissenting, expunged both deficiencies on the ground that the taxpayer had assigned property to his wife who received the payments from the trustee as income from that property and not as the assigned earnings of the taxpayer from his previously rendered personal services. This issue is reviewable as one of law, since it turns upon the proper construction of § 22(a) of the Internal Revenue Code, 26 U.S.C.A. Int. Rev. Code, 22(a), in the light of undisputed facts. *Cf. Trust of Bingham* v. *Commissioner,* 325 U.S. 365, 65 S. Ct. 1232, 89 L. Ed. 1670, 163 A.L.R. 1175.

It is of little significance that the taxpayer in his petition in the Tax Court chose to call his right to receive part of the royalties paid by the Eastman Kodak Company "an interest in the Kodachrome process" and the Commissioner accepted that definition of it in his answer. It now appears that the "interest" was only the right to receive a percentage of the royalties. And the tax consequences of the assignment of that right are, needless to say, dependent upon the real nature of what was assigned, not upon the label attached to it by the parties.

It has been well settled since *Lucas* v. *Earl,* 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731, that compensation derived from personal services is taxable to the one who performs the service whether or not he actually receives the compensation or transfers the right to receive it before it is earned. *Burnet* v. *Leininger,* 285 U.S. 136, 52 S. Ct. 345, 76 L. Ed. 665; *Commissioner of Internal Revenue* v. *Tower,* 327 U.S. 280, 66 S. Ct. 532, 537, 90 L. Ed. 670, 164 A.L.R. 1135. In *Helvering* v. *Eubank,* 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81, the principle was extended to cover the assignments of compensation due in the future for personal services performed in the past. We think the last mentioned case controlling in this instance. These payments were the result of personal services performed in the past by the taxpayer. The taxpayer did not receive for those services any part of the Kodachrome process itself or any right to control the disposition of that process. Rather, he obtained the enforceable promise of the owners of the process that he would be paid for his services a definite portion of the royalties they had the right to receive from the Eastman Kodak Company. That is to say, his "interest in the process" was never greater than a contract right to be paid certain ascertainable sums of money. From first to last his pay for his services was to be only in money determinable in amount by reference to a royalty agreement covering the process. This taxpayer's right to receive royalties, we think, is indistinguishable from the right, which was considered in *Helvering* v. *Eubank,*

supra, to receive part of past earned commissions on future premiums on insurance contracts. There also the assignment was of the taxpayer's right, title, and interest in the contract as well as the renewal commissions. As was said in *Commissioner of Internal Revenue* v. *Tower*, *supra*,

> A person may be taxed on profits earned from property, where he neither owns nor controls it. *Lucas* v. *Earl*, *supra*. The issue is who earned the income . . . 327 U.S. at page 289, 66 S. Ct. at page, 90 L. Ed. 670, 164 A.L.R. 1135.

The decision on the *Kodachrome* issue is reversed with directions to reinstate the deficiency for each year.

Note

Could one of the inventors have shifted his royalty income or a portion of it to a member of his family by an assignment of "the process itself" or of a fractional interest in it? Would it be relevant whether this was done after rather than before Kodak had been licensed to use the process? See *Dreymann* v. *Commissioner*, 11 T.C. 153 (1948); *Wodehouse* v. *Commissioner*, 177 F.2d 881 (2d Cir. 1949), *Wodehouse* v. *Commissioner*, 178 F.2d 987 (4th Cir. 1949).

2. *Trusts*

In the foregoing cases the courts had to determine which of *two* parties should be taxed on the income. We now turn to situations in which three parties are potential taxpayers: the owner of property transfers it to a trustee to administer, with instructions for distributing the income, now or hereafter, to a beneficiary. Who—the grantor, the trustee, or the beneficiary—is taxed on the income?

We may approach the answer by noting at the outset that the trust is a taxable entity, separate from both the grantor and the beneficiary, and that the trustee must file a return reporting its income. § 6012(b)(4). The trust's tax is computed in about the same way as an individual's, § 641(b),* with one major and several minor exceptions. Of the *minor* exceptions, those of chief interest are that (a) in lieu of the personal exemption and exemption for dependents allowed to individuals the trust gets a deduction of $100 ($300 for some trusts)† and (b) the deduction for charitable contributions is not restricted, as for individuals, to amounts actually paid during the taxable year not in excess of 20 or 30 per cent of adjusted gross income, but is instead unlimited and includes both amounts paid and those "permanently set aside" for charitable purposes. See §§ 642(b) and 642(c). The *major* exception is that, as a general principle, all distributions by the trust (to the extent of its current income) are deductible by the trust and taxable to the beneficiaries. §§ 651-663 Thus, all income earned by the trust property must be reported, but the beneficiaries are taxed on the amounts distributed to them and the trust is actually taxed only to the extent that its current income exceeds its distributions to the beneficiaries. When a trust distributes amounts in excess of its

* Special rules are prescribed, however, for employee's pension and similar trusts, § 501(e); for certain tax-exempt organizations in trust form, § 501(c), for alimony trusts, § 682, and for certain other trusts.

† It is occasionally necessary to determine whether a single indenture creates several trusts or only one, since each trust is entitled to its own deduction and to an individually calculated tax. See United States Trust Co. v. Commissioner, 296 U.S. 481 (1936), Hale v. Dominion National Bank, 186 F.2d 374 (6th Cir. 1951), cert. den. 342 U.S. 821; McHarg v. Fitzpatrick, 210 F.2d 792 (2d Cir. 1954).

current income, however, the beneficiaries are not taxed on the excess distributions, except that in general if within the previous five years the trust had undistributed income, the later excess distributions will be treated as belated distributions of trust income under a "throwback" rule and will be taxed accordingly to the beneficiaries. Since the trust will have been taxed on these amounts, the tax previously paid by the trust is credited to the beneficiaries.

Overriding this scheme, however, are certain rules requiring the income to be taxed to the grantor‡ of the trust where he has retained for himself either control over the trust or the benefits of the income. Some of these rules are set out in the Code itself, but the most spectacular developments in this area have been of judicial and administrative origin. When these rules are applicable, they take precedence and neither the trust nor the beneficiary is taxed.

As background for what follows, the student should examine §§ 676 and 677 with care. They are derived from, but are not identical with, §§ 166 and 167 of the 1939 Code.

CORLISS v. BOWERS

Supreme Court of the U. S., 1930
281 U.S. 376

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a suit to recover the amount of an income tax paid by the plaintiff, the petitioner, under the Revenue Act of 1924. The complaint was dismissed by the District Court, 30 F.(2d) 135, and the judgment was affirmed by the Circuit Court of Appeals, 34 F.(2d) 656. A writ of certiorari was granted by this Court.

The question raised by the petitioner is whether Sec. 219(g)* of the Revenue Act of 1924 can be applied constitutionally to him upon the following facts. In 1922 he transferred the fund from which arose the income in respect of which the petitioner was taxed, to trustees, in trust to pay the income to his wife for life with remainder over to their children. By the instrument creating the trust the petitioner reserved power "to modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created," etc. It is not necessary to quote more words because there can be no doubt that the petitioner fully reserved the power at any moment to abolish or change the trust at his will. The statute referred to provides that "where the grantor of a trust has, at any time during the taxable year, . . . the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Section 219(g) with other similar provisions as to income in § 219(h). There can be no doubt either that the statute purports to tax the plaintiff in this case. But the net income for 1924 was paid

‡ It should be noted that a person may be the grantor of a trust in substance though he was not the one who formally established it. For example, a husband may give property to his wife with a tacit understanding that she will create a trust. The husband will then be regarded as the grantor. Or, Smith may create a trust for the benefit of Jones' children and Jones, by prearrangement, may create a trust of equal value for the benefit of Smith's children. Each may be regarded as the creator of the other's trust. See generally Colgan and Molloy, "Converse Trusts—The Rise and Fall of a Tax Avoidance Device," 3 *Tax L. Rev* 271 (1948).

* The predecessor of § 166 of the 1939 Code and § 676 of the 1954 Code. [Ed.]

over to the petitioner's wife and the petitioner's argument is that however it might have been in different circumstances the income never was his and he cannot be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. The title would merely mean a right to stop the payment before it took place. The same right existed here although it is not called a title but is called a power. The acquisition by the wife of the income became complete only when the plaintiff failed to exercise the power that he reserved. *Saltonstall* v. *Saltonstall*, 276 U.S. 260, 271, 48 S. Ct. 225, 72 L. Ed. 565; *Chase National Bank* v. *United States*, 278 U S. 327, 49 S. Ct. 126, 73 L. Ed. 405, 63 A.L.R. 388; *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339, 49 S. Ct. 123, 73 L. Ed. 410. Still speaking with reference to taxation, if a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not. We consider the case too clear to need help from the local law of New York or from arguments based on the power of Congress to prevent escape from taxes or surtaxes by devices that easily might be applied to that end.

Judgment affirmed.

The CHIEF JUSTICE took no part in this case.

Note

1. As the case indicates, originally the income of a trust was taxed to the grantor if he had a power to revest "at any time *during the taxable year*." This rule could be avoided, with little loss of control, by a provision in the trust instrument allowing the grantor to revest the corpus in himself only if he had given noitce of his intention to do so during the previous year; if he had not signified his intent to exercise the power before the beginning of the taxable year, it could be argued that he had no power to revest "at any time during the taxable year." For this reason, the statute was amended in 1934 so that the grantor is taxable if he has a power to revest "at any time."

But the new phraseology also raised a question. Suppose the trust was irrevocable for 20 years, but revocable thereafter. The pre-1954 regulations appeared to tax the income to the grantor, see Regs. 118, Sec. 39.166-1(b)(1)(ii) and (iii), and *cf. Helvering* v. *Dunning*, 118 F.2d 341 (4th Cir. 1941), cert. den. 314 U.S. 631. But it was held in *Helvering* v. *Wood*, 309 U.S. 344 (1940), that a reversion is not equivalent to a "power to revest." That suggested the possibility that the income of a trust the corpus of which would automatically revert to the grantor at the end of 20 years would not be taxed to him, but that the income of a trust irrevocable for twenty years with a power in the grantor to revoke thereafter would be taxed to him.

A change in the 1954 Code eliminates this anomaly. Section 676 provides that in those circumstances where the income of a trust to terminate at the end of a given period is not taxed to the grantor, the income of a trust that is not revocable until the end of

the same period will also be taxed to the grantor, *i.e.*, if a reversionary interest will not count against the grantor, neither will a power to revoke that is postponed for the same period.

2. The Regulations state that a power to revest calls the statute into play even though "the exercise of such power is conditioned . . . on the happening of a specific event." Regs. 118, Sec. 39.166-1(b)(1)(ii). What if the corpus can revest in the grantor only if he is in extreme need, or if a named person dies? Section 166 of the 1939 Code spoke of a power to revest that "is vested" in the grantor. Relying on this phrase of § 166, in *Commissioner* v. *Betts*, 123 F.2d 534, 538 (7th Cir. 1941), a power to revest the corpus was held not to be "vested in the grantor" where his power "was remote, contingent, and uncertain with no assurance of its ever coming into existence." The legislative history of § 166 does not bear out the court's view that "vested" was used in contrast to "contingent" or that, when the word came into the statute in 1932, it was intended to be narrower than the pre-1932 language. H. Rept. No. 708, 72d Cong., 1st sess., 39-1 C.B. (Part 2) 457, 474; S. Rept No. 665, 72d Cong., 1st sess., *ibid.* 496, 520-521. The 1954 Code speaks of a power to revest that is "exercisable" by the grantor. Is the change material?

JOSELOFF v. COMMISSIONER

Tax Court of the U. S., 1947, 8 T.C. 213

HARLAN, Judge: The respondent justifies the taxation of the income of the two trusts involved herein to the settlor on two propositions:

(1) The settlor retained dominion and control over the trust property and remained in substance the owner thereof, and

(2) The trust is revocable by the settlor's wife, who does not have a substantial adverse interest in the disposition of the corpus or the income thereof.

[The court held that the settlor was not taxable on the trust income under the first of the government's two contentions.]

The second reason which respondent advances as to why the income of this trust should be taxed to the grantor is that the trust is revocable during the life of the grantor and before the beneficiary reaches the age of twenty-five by direction of the grantor's wife. The Commissioner contends that, under the trust instrument and the conditions surrounding it, the grantor's wife has no interest in the preservation of the trust adverse to that of the grantor and that therefore the corpus of the trust may be revested in the grantor, and under the provisions of section 166 of the Internal Revenue Code the income thereof is taxable to him.

It therefore becomes necessary for us to determine precisely what the interests of Lillian L. Joseloff, the wife of the grantor, are in the preservation of the trusts. Petitioner enumerates these interests as follows:

1. A legal interest, with pecuniary value, consisting of a contingent remainder in each trust.

2. A non-legal interest, with possible pecuniary value, consisting of (a) her right to receive income distributed to her by the Trustee without any duty to account therefor, (b) to receive principal advances free of supervision by the Trustee, and (c) to exercise her dominant position on the Committee of Control to procure a termination of either or both trusts.

The question of the substantial value of a remote contingent remainder such as exists in this case has frequently been decided, not only by this Court, but in other

tribunals. It must be remembered that if neither of these trusts is revoked, Lillian Joseloff, in order to realize on her contingent remainder, would be required to survive both of her daughters and the issue of both of her daughters. In the first taxable year Lillian was 44 years of age, Joan 13, and Carol 11. In a case almost identical with the one at bar, *Claire R. Savage*, 4 T.C. 286, the Court speaks of such a contingent remainder and says:

> We fail to see any substantial adverse interest in the respective grantor's spouse . . . which would deter his or her use of the power to amend for the grantor's benefit. . . . The interest of the spouse is that of a contingent remainderman, and it will vest, if at all, only upon the termination of the trust under almost impossible circumstances. . . . In order for her to benefit from either of these trusts she would have to outlive the survivor of the two minor children and their issue, if any. To hold that such a remote possibility of receiving benefit constitutes a 'substantial adverse interest' would do violence to the meaning of the word 'substantial' and to the intent of Congress. . . .

In *Cushman* v. *Commissioner*, 153 Fed.(2d) 510, the grantor of a trust for the benefit of his two minor children and their living issue, failed to divest himself of the possibility of reversion by operation of law. The court says:

> If all the grantor's children were to die without issue and if the last of them failed to exercise a valid appointment by will, the grantor, if living, might inherit some of the trust estate . . . but where the chance that the grantor will ever get anything is so remote as it is here, it certainly cannot be considered an economic benefit closely retained by the grantor.

To the same effect see *Frances Biddle Trust*, 3 T.C. 832; *Estate of Harris Fahnestock*, 4 T.C. 1096.

If it be contended that grantor's wife could at least remove the primary estate of one of her children and her living issue by revoking one of the trusts, her reversionary interest would still be contingent on surviving one minor daughter and the issue of this daughter and it could certainly not be contended that in revoking the trust to accomplish this very doubtful advantage to herself her act would be "adverse" to the interest of the grantor. Petitioner, however, argues that the grantor's wife has other interests in the preservation of this trust beside her contingent remainder, to wit, her right to receive income from the trustee without any duty to account therefor. The trust instrument, however, provides that all money so received shall be used for the "support, maintenance and education" of the beneficiary. For the wife to obtain any economic benefit from this money it would be necessary for her to misappropriate the funds and violate the terms of the trust. It could hardly be said that it would be to her interest to preserve a trust, the very terms of which prevent her from procuring any benefit from such income.

Petitioner says that the wife also has the right "to receive principal advances free of the supervision by the trustee." Such advances are those advanced from the principal recommended by the advisory committee to the trustee, but it is to be noted that the grantor himself, as long as he is living, has a very definite check on such advances, as the trust provides: "The trustee shall be under no obligation to act without the approval of said Morris Joseloff during his life." Thus the wife, without the consent of the grantor, in spite of the recommendation of the committee, would receive nothing from the trustee from the principal of the

trust. Her interest in such funds is certainly not adverse to the grantor, who is in a position to authorize or disapprove such advancements.

Petitioner further says that the wife, through her dominant position in the committee of control, could procure a termination of either or both trusts. This contention is far from clear. The committee has no power to terminate the trusts except by distributing portions of the corpus and, as shown above, this cannot be done without the approval of the settlor of the trusts. Furthermore, all of such disbursements must be "for her [the beneficiary's] benefit." Any benefit to Lillian Joseloff would be in the nature of an embezzlement under the terms of the trust.

Offsetting these speculative adverse interests of the wife in the preservation of the trust, it is at once evident that the wife possesses some very substantial interests, from a purely selfish viewpoint, in the revocation of the trusts. The grantor of this trust in 1938 was sixty years of age. If the corpora of these trusts had been revested in her husband in 1941, when he was sixty-three years of age, his estate would have been enriched by $666,201.2. The income of one-third of this, under the laws of Connecticut, would have inured to Mrs. Joseloff for life at the death of her husband. Furthermore, and from a practical viewpoint, if Morris Joseloff really desired the revocation of these trusts at any time, it would be much to Morris Joseloff's advantage to compensate his wife if necessary for any pecuniary interest she might think she would be losing by the revocation of the trusts. Furthermore, this trust is entirely a family affair. Both the settlor and his wife have but one interest, and that is the interest of the family unit. The fact that Mrs. Joseloff would deposit in these trust estates 2,000 shares of Sycamore Corporation common stock having a value of $61,174.49 and thereby make it possible for that stock, in the case of the revocation of the trust, to vest in her husband, without even requiring any agreeement other than a receipt therefor, given not to her, but to Morris, certainly is ample evidence that there is no adversity of interest between this settlor and his wife. If, in the face of adversity, the family interest required that these trusts be revoked and these trust funds revested in the head of the family for the purpose of creating a new family income, it would require a mind wholly aloof from human affairs to imagine for a minute that Mrs. Joseloff would not revoke these trusts, even though her husband, the grantor of the trusts, would not compensate her for her lost "adverse" interest. As was said in the case of *Fulham* v. *Commissioner*, 110 Fed.(2d) 916, at page 918, in judging the adversary interest of the person having the power of revocation where a family trust is involved, "realistic appraisal" is called for rather than a purely legalistic one. See also *Commissioner* v. *Casperson*, 119 Fed.(2d) 94.

The tenuous interests that Mrs. Joseloff has, if any, in the preservation of these trusts, as compared with the obvious tangible and immediate interests which she would achieve by the revocation of the trusts, in our opinion, require that her selfish interests in the trust be wholly on the side of their revocation and that those interests are not at all adverse to the interests of the settlor. It is, therefore, our opinion that the contentions of the respondent in this case should be sustained, but in view of certain other issues not mentioned herein which have been conceded by the respondent,

Decision will be entered under Rule 50.

Reviewed by the Court.

Leech, Black, Disney, and Kern, JJ., concur only in the result.

Note

1. See the comment of Judge Magruder, in *Commissioner* v. *Prouty,* 115 F.2d 331, 335 (1st Cir. 1940), a gift tax case, on the "element of unreality in the inquiry whether a beneficiary's interest is substantially adverse to the grantor." Suppose the trust corpus is worth $100,000, and the beneficiary whose consent to a revocation must be procured by the grantor is wholly independent, and has an interest worth $50,000. Is the grantor required to report half the income, or none at all?

2. Note that § 676 taxes the income of a trust to the grantor if a power to revest is exercisable by the grantor himself, by a "non-adverse party" (defined in § 672), or by the grantor in conjunction with such a person. The corpus of a trust will be included in the grantor's *estate* for estate tax purposes, however, if he retained a right to revest, either alone or in conjunction with *any* other person. Section 2038(a)(1); *Helvering* v. *City Bank Farmers Trust Co.,* 296 U.S. 85 (1935). Is there any reason why the corpus of a trust should be included in the grantor's estate even if the person whose consent is required has a substantial adverse interest when the income of the trust was not taxed to the grantor during his lifetime? In another respect, the estate tax is less exacting the corpus will not be part of the grantor's estate if the power to revest is entrusted to a third party alone, even if he does not have a substantial adverse interest. Why should such a trust insulate the grantor from estate tax but not from income tax?

The completeness of a transfer for *gift* tax purposes is governed by yet another set of rules. A transfer is subject to gift tax if the power to revest is entrusted to a third party alone, whether or not he has a substantial adverse interest. In this respect, the gift tax law resembles the estate tax law. At another point, however, the gift tax rule parallels the income tax, rather than the estate tax, rule· where the grantor retains the power to revest only with the consent of a person having a substantial adverse interest, the transfer is complete for gift tax purposes, as it is for income tax, although the trust will still be part of the grantor's estate. See Regs. 108, Sec. 86.3(a) (fifth paragraph), *Camp* v. *Commissioner,* 195 F.2d 999 (1st Cir. 1952). See generally Advisory Committee to Treasury Department and Office of Tax Legislative Counsel, *Federal Estate and Gift Taxes. A Proposal for Integration and for Correlation with the Income Tax* (1947), pp. 9-12.

3 The foregoing cases concerned powers to revest the *corpus* of a trust in the grantor If the power embraces only the *income* of the trust, § 677 is called into play. The grantor is taxed

(a) if the income is or may be* distributed to the grantor or held or accumulated for future distribution to him. §§ 677(a)(1) and 677(a)(2). It was held in *Helvering* v. *Stuart,* 317 U.S. 154 (1942), that this language would include any trust income that a trustee having no substantial adverse interest could apply for the support and education of the grantor's minor children, since he would be thereby relieved *pro tanto* of his parental obligations Section 677(b), added in 1943 as a result of the *Stuart* case, changes this rule as to income that could be, but is not, so applied, the grantor is now charged only with the income *actually* applied or distributed for support of his dependents.

(b) if the income is or may be* applied to the payment of premiums for life insurance on the grantor's life. Section 677(a)(3). The constitutionality of this provision was upheld in *Burnet* v. *Wells,* 289 U.S. 670 (1933). If the grantor has irrevocably assigned the policies, and has relinquished all rights to them, what is the reason for taxing him on income used to preserve or increase the value of property he no longer owns or controls?

If a power over income is to come into play only at the expiration of a period of time, it does not come within § 677 unless a reversionary interest at the end of the same period would cause the grantor to be taxed on the income.

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* In the discretion of the grantor, a "non-adverse party," or both.

HELVERING v. CLIFFORD

Supreme Court of the U. S, 1940
309 U.S. 331

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

In 1934 respondent declared himself trustee of certain securities which he owned. All net income from the trust was to be held for the "exclusive benefit" of respondent's wife. The trust was for a term of five years, except that it would terminate earlier on the death of either respondent or his wife. On termination of the trust the entire corpus was to go to respondent, while all "accrued or undistributed net income" and "any proceeds from the investment of such net income" was to be treated as property owned absolutely by the wife. During the continuance of the trust respondent was to pay over to his wife the whole or such part of the net income as he in his "absolute discretion" might determine. And during that period he had full power (a) to exercise all voting powers incident to the trusteed shares of stock; (b) to "sell, exchange, mortgage, or pledge" any of the securities under the declaration of trust "whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration" as respondent in his "absolute discretion may deem fitting"; (c) to invest "any cash or money in the trust estate or any income therefrom" by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property "without restriction" because of their "speculative character" or "rate of return" or any "laws pertaining to the investment of trust funds"; (d) to collect all income, (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of "other persons or in my own name as an individual" except as otherwise provided. Extraordinary cash dividends, stock dividends, proceeds from the sale of unexercised subscription rights, or any enhancement, realized or not, in the value of the securities were to be treated as principal, not income. An exculpatory clause purported to protect him from all losses except those occasioned by his "own wilful and deliberate" breach of duties as trustee. And finally it was provided that neither the principal nor any future or accrued income should be liable for the debts of the wife; and that the wife could not transfer, encumber, or anticipate any interest in the trust or any income therefrom prior to actual payment thereof to her.

It was stipulated that while the "tax effects" of this trust were considered by respondent they were not the "sole consideration" involved in his decision to set it up, as by this and other gifts he intended to give "security and economic independence" to his wife and children. It was also stipulated that respondent's wife had substantial income of her own from other sources; that there was no restriction on her use of the trust income, all of which income was placed in her personal checking account, intermingled with her other funds, and expended by her on herself, her children and relatives; that the trust was not designed to relieve respondent from liability for family or household expenses and that after execution of the trust he paid large sums from his personal funds for such purposes.

Respondent paid a federal gift tax on this transfer. During the year 1934 all income from the trust was distributed to the wife who included it in her individual return for that year. The Commissioner, however, determined a deficiency in

respondent's return for that year on the theory that income from the trust was taxable to him. The Board of Tax Appeals sustained that redetermination. 38 B.T.A. 1532. The Circuit Court of Appeals reversed. 8 Cir., 105 F.2d 586. We granted certiorari because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes. 308 U.S. 542, 60 S. Ct. 139, 84 L. Ed. 457.

Sec. 22(a) of the Revenue Act of 1934, 48 Stat. 680, 686, 26 U.S.C.A. Int. Rev. Acts, page 669, includes among "gross income" all

> gains, profits, and income derived ... from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. *Cf. Helvering* v. *Midland Mutual Life Insurance Co.*, 300 U.S. 216, 57 S. Ct. 423, 81 L. Ed. 612, 108 A.L.R. 436. Hence our construction of the statute should be consonant with that purpose. Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. See *Blair* v. *Commissioner*, 300 U.S. 5, 12, 57 S. Ct. 330, 333, 81 L. Ed. 465. In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation. And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as § 22(a) is concerned.

In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of § 22(a).

So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic

position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered. But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive § 22(a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before. Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of § 22(a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the "victim of despotic power when for the purpose of taxation he is treated as owner altogether." See *Du Pont* v. *Commissioner,* 289 U.S. 685, 689, 53 S. Ct. 766, 767, 77 L. Ed. 1447.

We should add that liability under § 22(a) is not foreclosed by reason of the fact that Congress made specific provision in § 166, 26 U.S.C.A. Int. Rev. Code, § 166, for revocable trusts, but failed to adopt the Treasury recommendation in 1934, *Helvering* v *Wood,* 309 U.S. 344, 60 S. Ct 551, 84 L. Ed. 796, that similar specific treatment should be accorded income from short term trusts Such choice, while relevant to the scope of § 166, *Helvering* v. *Wood, supra,* cannot be said to have subtracted from § 22(a) what was already there. Rather, on this evidence it must be assumed that the choice was between a generalized treatment under § 22(a) or specific treatment under a separate provision[1] (such as was accorded revocable trusts under § 166); not between taxing or not taxing grantors of short

[1] As to the disadvantage of a specific statutory formula over more generalized treatment see Vol I, Report, *Income Tax Codification Committee* (1936), a committee appointed by the Chancellor of the Exchequer in 1927. In discussing revocable settlements the Committee stated, p. 298: "This and the three following clauses reproduce section 20 of the Finance Act, 1922, an enactment which has been the subject of much litigation, is unsatisfactory in many respects, and is plainly inadequate to fulfill the apparent intention to prevent avoidance of liability to tax by revocable dispositions of income or other devices We think the matter one which is worthy of the attention of Parliament."

term trusts. In view of the broad and sweeping language of § 22(a), a specific provision covering short terms trusts might well do no more than to carve out of § 22(a) a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of § 22(a).

In view of this result we need not examine the contention that the trust device falls within the rule of *Lucas* v. *Earl,* 281 U.S. 111, 50, S. Ct. 241, 74 L. Ed. 731, and *Burnet* v. *Leininger,* 285 U.S. 136, 52 S. Ct. 345, 76 L. Ed. 665, relating to the assignment of future income, or that respondent is liable under § 166, taxing grantors on the income of revocable trusts.

The judgment of the Circuit Court of Appeals is reversed and that of the Board of Tax Appeals is affirmed.

It is so ordered.

Reversed.

Mr. Justice Roberts.

I think the judgment should be affirmed.

The decision of the court disregards the fundamental principle that legislation is not the function of the judiciary but of Congress.

In every revenue act from that of 1916 to the one now in force a distinction has been made between income of individuals and income from property held in trust. It has been the practice to define income of individuals, and, in separate sections, under the heading "Estates and Trusts," to provide that the tax imposed upon individuals shall apply to the income of estates or of any kind of property held in trust. A trust is a separate taxable entity. The trust here in question is a true trust.

While the earlier acts were in force creators of trusts reserved power to repossess the trust corpus. It became common also to establish trusts under which, at the grantor's discretion, all or part of the income might be paid to him, and to set up trusts to pay life insurance premiums upon policies on the grantor's life. The situation was analogous to that now presented. The Treasury, instead of asking this court, under the guise of construction, to amend the act, went to Congress for new legislation. Congress provided, by § 219(g) (h) of the Revenue Act of 1924, that if the grantor set up such a life insurance trust, or one under which he could direct the payment of the trust income to himself, or had the power to revest the principal in himself *during any taxable year,* the income of the trust, for the taxable year, was to be treated as his.

After the adoption of these amendments taxpayers resorted to the creation of revocable trusts with a provision that more than a year's notice of revocation should be necessary to termination. Such a trust was held not to be within the terms of § 219(g) of the Revenue Act of 1924, 43 Stat. 277, because not revocable within the taxable year.

Again, without seeking amendment in the guise of construction from this court, the Treasury applied to Congress, which met the situation by adopting § 166 of the Revenue Act of 1934, 26 U.S.C.A. Int. Rev. Code, § 166, which provided that, in the case of a trust under which the grantor reserved the power

at any time to revest the corpus in himself, the income of the trust should be considered that of the grantor.

The Treasury had asked that there should also be included in that act a provision taxing to the grantor income from short term trusts. After the House Ways and Means Committee had rendered a report on the proposed bill, the Treasury, upon examination of the report, submitted a statement to the Committee containing recommendations for additional provisions; amongst others, the following:

> (6) The income from short-term trusts and trusts which are revocable by the creator at the expiration of a short period after notice by him should be made taxable to the creator of the trust.

Congress adopted an amendment to cover the one situation but did not accept the Treasury's recommendation as to the other. The statute, as before, clearly provided that the income from a short term irrevocable trust was taxable to the trust, or the beneficiary, and not to the grantor. . . .

The fact that the petitioner is in truth asking us to legislate in this case is evident from the form of the existing regulation and from the argument presented. The important portion of the regulation reads as follows:

> In determining whether the grantor is in substance the owner of the corpus, the Act has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are The fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make, and any other circumstance bearing on the impermanence and indefiniteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

In his brief the petitioner says:

> On the other hand, the income of a long term irrevocable trust which committed the possession and control of the corpus to an independent trustee *would not likely* be taxed to the settlor merely because of a reversionary interest. The question here, as in many other tax problems, *is simply one of degree.* The grantor's liability to tax must depend upon whether he retains so many of the attributes of ownership as to require that he be treated as the owner for tax purposes, or whether he has given up the substance of his dominion and control over the trust property.
>
> Under these circumstances, the question of *precisely where the line should be drawn* between those irrevocable trusts which deprive the grantor of command over the trust property and those which leave in him the practical equivalent of ownership is, in our view, *a matter peculiarly for the judgment of the agency charged with the administration of the tax law.* (Italics supplied.)

It is not our function to draw any such line as the argument suggests. That is the prerogative of Congress. As far back as 1922, Parliament amended the British Income Tax Act, so that there would be no dispute as to what short term trust income should be taxable to the grantor, by making taxable to him any income which, by virtue of any disposition, is payable to, or applicable for the benefit of, any other person for a period which cannot exceed six years.

If some short term trusts are to be treated as non-existent for income tax purposes, it is for Congress to specify them.

MR. JUSTICE MCREYNOLDS joins in this opinion.

Note

1 In *DuPont* v. *Commissioner*, 289 U.S. 685, 688-89 (1933), the Court had unanimously agreed that the income from a three-year trust should be taxed to the grantor, on the ground that he

> did not divest himself of title in any permanent or definitive way, did not strip himself of every interest in the subject-matter of the trust estate. . . . The situation in its legal effect would not be greatly different if the trusts had been created for a month or from day to day.

The holding in the *Clifford* case was even more clearly foreshadowed by *Douglas* v. *Willcuts*, 296 U.S. 1, 9-10 (1935), deciding that a husband was taxable on the income of an "alimony trust" and saying.

> We do not regard the provisions of the statutes as to the taxation of trusts, fiduciaries and beneficiaries [§§676-677, 1954 Code], as intended to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him. . . . [W]e find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it.

See Paul, *Selected Studies in Federal Taxation*, Third Series (1940) 166, 200 ff; Surrey, "The Supreme Court and the Federal Income Tax. Some Implications of the Recent Decisions," 35 *Ill. L.Rev.* 779, 794-816 (1941).

2. The vagueness of the Court's criteria and the fertility of the tax advisor's imagination conspired to monopolize the time of the lower courts for years after the *Clifford* case was decided Countless cases involving application of the *Clifford* "doctrine" to trust income were decided between 1940 and 1946.

3. On December 29, 1945, the Treasury issued T.D. 5488, the so-called "Clifford Regulation," which, with minor modifications, appears as § 39.22(a)-21 of Regulations 118. The regulation, instead of relying on a judicial balancing of all the circumstances, laid down mechanical rules for determining when the grantor should be regarded as the owner in substance of the trust and hence taxable on its income. If the trust was to last for less than ten years (sometimes the period could be extended to fifteen years), *or* if the grantor had the power to determine or control the beneficial enjoyment of the income or corpus, *or* if he had administrative control over the trust that could be exercised primarily in his own interest, the income was taxable to him under the regulation. (The circumstances just summarized are defined and qualified in the regulation in some detail, as an examination of it will disclose.) The rules embodied in the regulation were derived from the *Clifford* line of cases, but it was not a restatement of the law, and it singled out a number of individual factors and made them alone responsible for imputing the income to the grantor, where the courts had ordinarily relied on the combined effect of several factors. See Alexandre, "A Case Method Restatement of the New Clifford Regulations," 3 *Tax L. Rev.* 189 (1947). In promulgating the regulation, the Treasury announced that it would be applied prospectively only. Where its terms were more favorable to the taxpayer than the case law, however, the Bureau announced that it would follow the regulation even as to pre-1946 years if no inconsistent claims were asserted by the trustees or beneficiaries. Mim. 5968, 46-1 C.B. 25; Mim. 6156, 47-2 C.B. 13.

4. For a lively debate on the *Clifford* regulation, see Pavenstedt, "The Treasury Legislates: The Distortion of the Clifford Rule"; Eisenstein, "The Clifford Regulations and the Heavenly City of Legislative Intention", with a "reply" and a "supplemental reply" by Pavenstedt, and a "postscript" by Eisenstein, all to be found in 2 *Tax L. Rev.* 7, 327, 476, 569, and 578 (1946-47).

5. The 1954 Code enacted statutory rules, based largely on the *Clifford* regulation, to govern this area:

(*a*) § 673 provides that the grantor shall be treated as the owner of a trust if he has a reversionary interest in either the corpus or the income that will or may reasonably be expected to take effect in possession or enjoyment within ten years. There are two

exceptions. One is that a reversionary interest to take effect after the death of the income beneficiary, no matter what his life expectancy, does not count against the grantor. The other exception is a reversionary interest if the income is irrevocably payable for at least two years to a single designated church, hospital, or educational institution. As the bill was originally proposed by the House Committee on Ways and Means, the income was excluded from the grantor's gross income, and he also would have been entitled to a charitable deduction for the present value of the income when the trust was established. It was pointed out in the minority report on the bill (H. Rept. pp. B10-11) that.

> Accordingly, the taxpayer who owns income-producing property and whose highest tax rate is greater than 50 percent can actually make money by supposedly satisfying his philanthropic desires.
>
> For example, if the taxpayer's highest tax rate is 90 percent and he owns property producing a yearly income of $5,000, over 2 years he will have $10,000 in income, pay $9,000 in taxes, and retain $1,000 after taxes. However, if the taxpayer desires to increase his retained income from the property 800 percent, he need only make a gift of the 2-year income in trust for a charity. The charitable deduction of approximately $10,000 to which he thereby becomes entitled will reduce the taxes he would otherwise pay by $9,000. Thus, by giving up, through the charitable gift, the $1,000 which he would have retained after taxes, he will receive in exchange a $9,000 reduction in taxes. The result is an increase of $8,000 in his income after taxes (the saving in taxes of $9,000 less the net gift, after taxes, of $1,000 of income).
>
> Similarly, a taxpayer in the 75-percent bracket will double his retained income from the property through the 2-year gift in trust; the taxpayer in the 60-percent bracket will increase his retained income by 50 percent; and the taxpayer in the 50-percent bracket will be able to make the "gift" without giving up any money.
>
> Obviously, the only charitable impulses that are involved in this provision are those toward the upper-income taxpayer. If it becomes law such 2-year trusts will mushroom and be, in time, a severe blow to the revenue.
>
> We are pleased that the majority have agreed to offer a floor amendment which will eliminate this loophole.

The bill was amended on the floor of the House to disallow the charitable deduction with respect to such trusts. See § 170(b)(1)(D).

(*b*) § 674 provides that the grantor shall be taxed upon the income of the trust if the beneficial enjoyment of the corpus or the income is subject to control by him, by a "nonadverse" party, or by both, without the approval or consent of an adverse party. A power to add new beneficiaries would ordinarily, and a power to reshuffle the interests of the named beneficiaries would sometimes, be embraced in this section. A number of more or less restricted powers to affect the interests of the beneficiaries are excepted. Moreover, while in general a power that would be charged against the grantor is equally fatal if it is held by a "nonadverse" party, § 674(c) excepts certain powers if they are vested in trustees who are not "related or subordinate parties who are subservient to the wishes of the grantor." See § 672(c). Section 674(d) allows certain other more restricted powers to be vested in anyone other than a grantor or a spouse living with him.

(*c*) § 675 provides that the grantor shall be treated as the owner of a trust if he, a nonadverse party, or both, may exercise certain administrative powers over the corpus or income.

6. The argument in the *Clifford* case over whether the sections specifically requiring the income of certain trusts to be taxed to the grantor (§§ 166 and 167 of the 1939 Code, now §§ 676 and 677 of the 1954 Code) precluded resort to the more general language of §22(a) of the 1939 Code is echoed in § 671 of the 1954 Code. It provides that the grantor shall not be taxed on the income of a trust "solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart." Suppose the corpus of a trust consists of cash, and the grantor supervises the use of the funds in

business transactions where his personal skill is great. Could the profits be taxed to him under the general language of § 61? See S. Rept. p. 365.

COMMISSIONER v. CLARK

U. S. Court of Appeals, Seventh Circuit, 1953
202 F.2d 94

Before MAJOR, Chief Judge, and FINNEGAN and SWAIM, Circuit Judges

MAJOR, Chief Judge.

These are petitions to review a decision of the Tax Court holding that the income of certain charitable trusts for the year 1946 was not properly taxable to the respondents, as asserted by the Commissioner. The two cases were considered together by the Tax Court inasmuch as each presented identical questions for decision. They are similarly presented to this court and will be treated accordingly.

There is no dispute concerning the facts as found by the Tax Court, which follow a stipulation entered into by the parties. However, even though only a question of law is involved, we think a statement of the facts is material.

Respondents (sometimes referred to as petitioners) are sisters. Forest Park Home Foundation (called the Foundation) was organized as an Illinois not-for-profit corporation in 1939. It is a donee, contributions to which are deductible under § 23(o)(2) of the Internal Revenue Code [§ 170, 1954 Code]. The purpose of the Foundation was to meet the need in the Peoria, Illinois, community for the care, maintenance and establishment of a home for the aged. Under its charter and bylaws, gifts could not revert to the donors and, in the event of the dissolution of the Foundation, its assets were distributable to other charities. The Foundation was organized by three Peoria citizens, of whom one, W. H. Sommer, was the father of petitioners. Petitioners being interested in the Foundation's program, each, on December 1, 1941, executed separate and identical deeds of trust. Such trusts contained the following provisions (in the language of the Tax Court):

> Each petitioner transferred 15,000 shares of the common stock of the Keystone Steel and Wire Company of Peoria, Illinois, to the Foundation which was trustee and beneficiary. Each trust was to be irrevocable for five years, though it could be extended. At the expiration of the term, the corpus of each trust, but no accumulation of income, would be returned to the settlor. The trust agreements expressly provided that all income from the trust estate was to be applied to the general charitable purposes of the Foundation and was not in any way to be retained as part of the trust corpus. During the period of the trusts, the trustee was to have "full and complete control of the trust assets, and all the powers and rights in and in connection with said trust assets, to the same extent as though the stock had been transferred to the name of Forest Park Home Foundation on the books of the Corporation." In the event of dissolution of the Foundation, the trusts' assets were to go to other charities, expressly prohibiting return to the grantors. The trust agreements provided that the trusts could be extended, but forbade any shortening The trusts further provided that only a currently equivalent number of shares of Keystone stock were to be returned to the settlors at the end of the trust term without accruals or additions because of income or profits.

Six days after the creation of the trusts came the attack upon Pearl Harbor. It shortly became apparent that the original schedule of five years for establishing the home was inadequate. The rising costs of construction and the war economy made it evident that more funds, as well as more time, would be necessary. Accordingly, on December 1, 1942, petitioners extended the irrevocable period of the trusts for

at least five additional years to December 1, 1951, all other provisions remaining unchanged. In the taxable year 1946, the Foundation was directed by a board of directors of nine members representing a cross-section of the Peoria community. Neither of the petitioners was a director, but three of their relatives were.

Also (in the language of the Tax Court):

> Under the terms of the trusts petitioners had no power with respect to the administration of the trusts or the distribution of the income therefrom. Moreover, the petitioners did not and have not attempted, either directly or indirectly, to influence or control the decisions of the board of directors of the Foundation as trustee or beneficiary under the trusts.
>
> The program contemplated by the Foundation has been carried out during the 10-year period in that a 125-bed home has been built and is occupied by inmates and the charity is functioning as intended by its founders.
>
> During the taxable year 1946, the Foundation received dividends of $42,750 on the 15,000 shares of stock transferred originally by each petitioner to the trusts dated December 1, 1941.

Further (in the language of the Tax Court):

> Petitioners received no benefits directly or indirectly from the trusts. Under the terms of the trusts petitioners retained no powers of disposition of income or corpus by revocation, alteration, or otherwise.

For the year 1946, petitioner Clark returned a net taxable income of $13,585.83, and petitioner Rutherford returned a net taxable income of $14,903.92. The Commissioner assessed a deficiency on the basis of $42,750.00 additional income to each petitioner, which represented the income received by the Foundation from dividends on the shares of stock transferred by the trust indentures to the Foundation. A deficiency was assessed against petitioner Clark for $27,946.62, and against petitioner Rutherford for $28,801.93. In view of the discussion to follow, it is interesting and perhaps of some pertinency to note that the Commissioner determined deficiencies against each of the petitioners for the years 1944 and 1945, upon the same basis that deficiencies were determined for the year 1946. However, as pointed out by the Tax Court, it was stipulated that there were no deficiencies for those years. Also, each of the petitioners created a trust indenture dated June 29, 1943, which was irrevocable until June 29, 1953, or for a period of ten years. These indentures contained the same provisions and were for the same purpose as the trusts created December 1, 1941 and now in dispute. The Commissioner determined deficiencies on the income from these 1943 trusts but, as the Tax Court stated:

> The respondent [Commissioner] now concedes that the dividends . . . are not taxable to petitioners because each trust had a duration of 10 years.

The Tax Court stated the question of law before it as:

> . . . whether the settlor-petitioners should be taxed on the charitable trust income solely because the duration of the trust is nine instead of 10 years, since the settlors have given up all other economic and legal aspects of ownership. Respondent [Commissioner] concedes in his brief that if the trusts in question were for a period of 10 years, the income therefrom is not taxable to petitioners.

The Tax Court stated:

> Respondent contends that under the Clifford regulations, Regulations 111, section 29.22(a)-21 [now Regs. 118, Sec. 39.22(a)-21], these trusts are nine year trusts and taxable.

The Tax Court, after pointing out that the trusts were irrevocable, were to run for a period of at least nine years as extended on December 1, 1942, and that petitioners during such time retained no power or control over either the corpus or the income, none of which was to be applied for the benefit of any member of petitioners' family group, concluded.

We hold that the income of the trusts for the taxable year in question was not taxable to petitioners under section 22(a) of the Internal Revenue Code or *Helvering* v *Clifford*, *supra*, [309 U.S 331, 60 S.Ct 554, 84 L Ed. 788] or Treasury Regulations 111, section 29.22(a)-21. We do not think *Helvering* v. *Clifford*, *supra*, or section 29.22(a)-21 of Regulations 111 were intended to or do apply to the income of a trust such as we have here.

It is not clear on what basis the Tax Court refused to give effect to the regulation relied upon by the Commissioner. It could have been because the court treated the duration of the trusts as of ten years, in which case the regulation was inapplicable; it could have been because the court thought the regulation should not be given effect retroactively, and it is possible that the court regarded the regulation as unreasonable and, therefore, void as beyond the power of the Treasury to promulgate.

Obviously, the question for decision here is whether the Tax Court erred in rejecting Commissioner's determination of a deficiency in the income tax returns of the petitioners for the year 1946 and in holding that the income of the trusts for said year was not taxable to petitioners.

Section 22(a) of the Internal Revenue Code, 26 U.S.C.A. § 22, generally defines "gross income" as follows:

"Gross income" includes gains, profits, and income derived from . . . interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

The full sweep of this provision has been often explored by courts and others and we suspect the process will continue indefinitely. Particularly is this so when the income in question is derived from property held in trust, as in the instant situation. Whether such income is that of the settlor, the trustee, or the beneficiary is oftentimes difficult to ascertain. The many cases furnish numerous guides to be employed in making such determination but the adjudicated law can hardly be said to be settled. In *Helvering* v. *Stuart*, 317 U.S. 154, 168, 63 S. Ct. 140, 148, 87 L. Ed. 154, the court stated:

Economic gain realized or realizable by the taxpayer is necessary to produce a taxable income under our statutory scheme. That gain need not be collected by the taxpayer. He may give away the right to receive it as was done in *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, *Helvering* v. *Eubank*, 311 U.S. 122, 125, 61 S. Ct. 149, 150, 85 L. Ed. 81, and *Harrison* v. *Schaffner*, 312 U.S. 579, 61 S. Ct. 759, 85 L. Ed. 1055. But the donor nevertheless had the "use [realization] of his economic gain." 311 U.S. at 117, 61 S. Ct. at page [144], 147. In none of the cases had the taxpayer really disposed of the res which produced the income.

The cases disclose that many factors have been utilized by courts in ascertaining whether a trust-settlor has from the trust income realized an economic gain. The most important case perhaps and certainly the most controversial is that of *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788. There, the court sustained the decision of the Tax Court which had held that the settlor was the owner

of the corpus after the trust was created and was, therefore, chargeable with its income. The court mentions numerous factors which led to this conclusion, such as the short duration of the trust, the fact that the wife was the beneficiary, and the control which the settlor retained over the corpus. The court pointed out, 309 U.S. at page 335, 60 S. Ct. at page 556.

> In substance his control over the corpus was in all essential respects the same after the trust was created, as before. . . . We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact.

The court further stated, 309 U.S. at page 336, 60 S. Ct. at page 557.

> Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of § 22(a).

It was the "bundle of rights" retained by the settlor from which the court concluded that the husband remained the owner of the trust property and, therefore, chargeable with its income.

Many cases have been decided since *Clifford*. A reading of these cases reveals that the doctrine there announced has led to some confusion and that its application has been found difficult in particular cases. We shall not attempt to discuss these many cases but we think it can be rather firmly asserted that they all in the main employ the factors enumerated in *Clifford*. The Commissioner appears to so recognize because he concedes that his determination of deficiencies in petitioners' tax returns for 1944 and 1945 was erroneous.

The Commissioner, in support of his determination of deficiencies for 1946, relies solely upon Treasury Regulation 111, promulgated under the Internal Revenue Code on December 29, 1945, and applicable to taxable years commencing January 1, 1946. The pertinent portion of this regulation is § 29.22(c)–21, which provides:

> Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment—
> (1) within ten years commencing with the date of the transfer. . . .

Petitioners attack the regulation upon three grounds: (1) its application to the instant situation would give it a retroactive effect and, in any event, the trusts are not merely for nine years, as asserted by the Commissioner, but are ten-year trusts; (2) the regulation is unreasonable and arbitrary and, therefore, void, and (3) it is unconstitutional inasmuch as it deprives petitioners of their property without due process, that is, without a hearing on the issues existing between the taxpayer and the Commissioner and which arise because of the deficiencies asserted by the Commissioner.

We agree with the petitioners in all three contentions. Assuming that the regulation is valid, it is not discernible on what basis it should be applied to the income of trusts which had been in existence for some four or five years prior to its promulgation. By such application, income from the trust property which the

Commissioner concedes was not that of petitioners prior to 1946 becomes that of the petitioners in 1946 and thereafter. Moreover, we think the trusts were for the duration of not less than ten years, and certainly this was so on January 1, 1946, when the regulation became effective, and for that reason the regulation cannot be properly applied.

More important, the regulation is void because it is unreasonable and arbitrary. Our conclusion in this respect is closely intertwined with our view that it is also unconstitutional, and the two issues can be treated together. We recognize that courts have indulged in considerable liberality in sustaining regulations adopted by administrative agencies. But, as was stated in *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 134, 56 S. Ct. 397, 400, 80 L. Ed. 1010:

> The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity.

Under the relevant section of the Revenue Act, the question as to whether the income from the trusts was that of petitioners was one of fact. It has been so treated and regarded from time immemorial. It was a factual issue upon which the Tax Court was charged with hearing all relevant testimony and making its findings. As was stated in *Hormel* v. *Helvering*, 312 U.S. 552, 556, 61 S.Ct. 719, 721, 85 L. Ed. 1037.

> And the basic reasons which support this general principle applicable to trial courts make it equally desirable that parties should have an opportunity to offer evidence on the general issues involved in the less formal proceedings before administrative agencies entrusted with the responsibility of fact finding

And again, 312 U S on page 560, 61 S. Ct. 723, the court stated

> Congress has entrusted the Board with exclusive authority to determine disputed facts. Under these circumstances we do not feel that petitioner should be foreclosed from all opportunity to offer evidence before the Board on this issue, however remote may be his chance to take his case out of the *Clifford* rule

In the *Clifford* case, 309 U.S. 331, at page 336, 60 S. Ct. 554, 557, the court stated:

> Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue.

It must be kept in mind that the regulation does not merely create a rebuttable presumption; it is conclusive. When it appears that the trust is for a period of less than ten years, that *ipso facto* determines that the income is that of the settlor. If this regulation is to stand, it means that in reality there is no issue for the Tax Court to determine. There could be no purpose in the taxpayer offering or in the Tax Court hearing evidence as to the factors involved in the situation. In the instant case, if the Tax Court had given effect to this regulation, as the Commissioner urged, there would have been no occasion and no reason for it to consider the facts and make findings. They would have been immaterial.

Petitioners, after the creation of these trusts, rested secure in the belief that they were not the owners of the income derived therefrom and that it was of no eco-

nomic benefit or gain to them. Every adjudicated case of which we are aware would have sustained that belief and we doubt if a competent lawyer could have been found who would have disagreed. The Commissioner tacitly concedes as much because he admits that the income was not that of petitioners for the years 1944 and 1945. Without any alteration in the trust indentures and without any change in the relation of any of the parties thereto, that which was not income of petitioners in 1944 and 1945 became such in 1946. This remarkable transformation results, according to the Commissioner, from the regulation under discussion. It is a result based upon fiction rather than the actualities of the situation. The result is so unreasonable and unfair as to be shocking. The regulation is in conflict with § 22(a) and with all adjudicated cases. We think it is void.

As noted, the regulation which decrees that the income from a trust is that of the settlor for the sole reason that its duration is for a period of less than ten years creates a conclusive or irrebuttable presumption. Such a presumption states a rule of substantive law. This is in contrast to a rebuttable presumption which only states a rule of evidence and which the opposing party is entitled to overcome by proof. *United States* v. *Jones*, 9 Cir., 176 F.2d 278, 288. And the Supreme Court has held that a statute which creates a conclusive presumption under circumstances closely akin to those of the instant case contravenes the Fourteenth Amendment if enacted by state legislature and the Fifth Amendment if enacted by Congress.

In *Schlesinger* v. *State of Wisconsin*, 270 U.S. 230, 46 S. Ct. 260, 70 L. Ed. 557, the Supreme Court struck down as violative of the Fourteenth Amendment a statute of the State of Wisconsin which provided in effect that gifts of a decedent's estate made within six years of his death were made in contemplation thereof. The court, 270 U.S. at page 239, 46 S. Ct. at page 261, stated:

> The challenged enactment plainly undertakes to raise a conclusive presumption that all material gifts within six years of death were made in anticipation of it and to lay a graduated inheritance tax upon them without regard to the actual intent. The presumption is declared to be conclusive and cannot be overcome by evidence. It is no mere prima facie presumption of fact.

In *Heiner* v. *Donnan*, 285 U.S. 312, 52 S. Ct. 358, 76 L. Ed. 772, the court likewise struck down a congressional enactment which created a conclusive presumption that gifts made within two years prior to the death of the donor were made in contemplation of death, on the ground that the provision violated the Fifth Amendment of the Constitution. The court pointed out, 285 U.S. at page 324, 52 S. Ct. at page 360, that Congress had the power to create a rebuttable presumption, and stated:

> But the presumption here created is not of that kind. It is made definitely conclusive —incapable of being overcome by proof of the most positive character.

The court discussed the *Schlesinger* case, 270 U.S. 230, 46 S. Ct. 260, and pointed out, 285 U.S. at page 325, 52 S. Ct. 358, that the only difference between the two cases was that the former considered an enactment of the Wisconsin legislature which violated the Fourteenth Amendment, while the case under consideration involved a congressional enactment which violated the Fifth Amendment. The court, 285 U.S. at page 327, 52 S. Ct. at page 361, stated:

> The presumption here excludes consideration of every fact and circumstance tending

to show the real motive of the donor. The young man in abounding health, bereft of life by a stroke of lightning within two years after making a gift, is conclusively presumed to have acted under the inducement of the thought of death, equally with the old and ailing who already stand in the shadow of the inevitable end.

And further the court stated, 285 U.S. at page 329, 52 S. Ct. at page 362:

This court has held more than once that a statute creating a presumption which operates to deny a fair opportunity to rebut it violates the due process clause of the Fourteenth Amendment.

In *Hoeper* v. *Tax Commission of Wisconsin*, 284 U.S. 206, 52 S. Ct. 120, 76 L. Ed 248, a statute of the State of Wisconsin which authorized an assessment of tax against a husband computed on the combined total of his and his wife's income was held unconstitutional, in violation of the Fourteenth Amendment. The court reaffirmed its holding in the *Schlesinger* case, 270 U.S. 230, 46 S. Ct. 260. The court stated, 284 U.S. at page 215, 52 S. Ct. at page 122:

That which is not in fact the taxpayer's income cannot be made such by calling it income.

It thus appears that even Congress would be without power to create the conclusive presumption which the Treasury has done in the regulation under attack. It is even more certain that an administrative agency is without authority to promulgate such a regulation. We conclude it is void because it violates the Constitution and, in any event, is in conflict with the congressional enactment on the subject and is arbitrary and unreasonable.

The decision of the Tax Court is Affirmed.

Note

Is § 673(a) of the 1954 Code unconstitutional?

On the question of calculating the term of a trust under § 673(a) when its period has been extended, see § 673(d).

FALK v. COMMISSIONER

U. S. Court of Appeals, Third Circuit, 1951
189 F.2d 806, cert. den. 342 U.S. 861

Before McLaughlin, Staley, and Hastie, Circuit Judges.

McLaughlin, Circuit Judge.

The only issue before us is whether the income of a trust (created by the petitioner's father in 1927) over and above the amounts payable thereunder to petititioner's sister, is includible in the taxpayer's gross income for the taxable year 1943. . . .

Most of the facts are stipulated and the balance are established by the evidence at the Tax Court hearing. Petitioner is forty-eight years old. He was born in Pittsburgh, Pennsylvania. For the last fifteen years he has been active there in philanthropic and community affairs. On November 11, 1927, his father, Leon Falk, executed a deed of trust with himself as donor and his brother, Maurice, as trustee. Leon Falk died October 20, 1928 without having terminated the trust. Maurice Falk served as trustee until his death March 18, 1946. Since that time his successor trustee, Fidelity Trust Company of Pittsburgh, has so served. During the period from the creation of the trust until his death, Leon Falk, as empowered by the deed of trust, directed his brother as trustee to pay from the income of the

trust estate a total of $23,250 to certain charitable, benevolent and educational institutions. Those monies were duly paid. From the date of the death of his father to the date of the death of Maurice Falk, it appears that the petitioner, as authorized by the trust, directed certain charitable and philanthropic payments to be made from the trust estate. Those payments were made and, exclusive of certain payments to the University of Pittsburgh, totalled $318,004.31. They were deducted by the trust estate from its gross income during the respective years in which the contributions were made. In 1943 the trust estate paid out a total of $51,318.75 to various charitable, benevolent and educational institutions. All of those payments were at the written direction of petitioner. The amount of the payments was deducted by the trust estate from its 1943 gross income. The Tax Court upheld the Commissioner in determining that the net income of the trust (which excluded certain sums paid petitioner's sister) was to be included in petitioner's income and that the above mentioned disbursements constitute gifts to charity by the petitioner under his voluntary designations.

The governing language of the November 11, 1927 deed of trust is Article Second which provides:

Second· The Trustee shall pay over the dividends, interest and income from the trust estate, remaining after payment thereout of the expenses of maintenance, taxes or other proper disbursements, as follows:

1. To Marjorie Falk, the daughter of the Donor, there shall be paid annually in quarterly instalments, as near as may be, such portion of said income as the Donor in his lifetime and Leon Falk, Jr, the son of the Donor, after the death of the Donor, shall from time to time in writing direct, provided, however, that after the death of the Donor the amount so paid shall not be less than Five Thousand Dollars per year. The payments so to be made to said Marjorie Falk shall be made each year until the trust is terminated.

2. To such charities and benevolences, charitable, benevolent and educational institutions as the Donor in his lifetime, and as Leon Falk, Jr., after the death of the Donor shall, from time to time in writing, designate, there shall be paid such portion of said income as the Donor in his lifetime and Leon Falk, Jr., after the Donor's death shall direct, each year until the trust is terminated.

3. To Leon Falk, Jr, the son of the Donor, there shall be paid annually all of said income which shall not be paid to said Marjorie Falk and to charitable, benevolent and educational purposes as aforesaid. The payments so to be made shall be made each year until the termination of the trust.

By Paragraph 3 of the Second Article of the trust, the taxpayer was to receive its annual income less payments of at least $5,000 a year to his sister and less any payments directed by him to be paid to charities and benevolences, charitable, benevolent and educational institutions designated by him in writing in accordance with Paragraph 2 of the Second Article. There is no language in the article or in the agreement making it mandatory on the taxpayer to give anything to charity, etc. or even to make specific designations of a particular charity. There is not the slightest ambiguity about Article Second. It is impossible to construe Paragraphs 2 and 3 with a reasonable regard for their rational meaning and to arrive at the conclusion that they obligated the taxpayer to designate the type of charity and benevolence as mentioned in Paragraph 2 and to then direct that sums certain be paid them under the trust.

The taxpayer does not possess all of the incidents of ownership but within the exception provided for of disbursements to his sister, he does have practical control

of the trust income. As Judge L. Hand said in *Stix* v. *Commissioner*, 2 Cir., 152 F.2d 562, 564, "All else he might withhold, and whatever more he chose to give, he gave out of his own." See also *Mallinckrodt* v. *Nunan*, 8 Cir., 146 F.2d 1, certiorari denied 324 U.S. 871, 65 S. Ct. 1017, 89 L. Ed. 1426. Under the wording of the trust deed we are unable to find that the petitioner had a duty to designate "charities, benevolences, charitable, benevolent and educational institutions" in writing and to direct specific payments to them of trust income. Such designation and direction was left to the absolute discretion of the petitioner. With the exception of mandatory payments to his sister, he was unfettered in his control of the trust income. This is ample to bring it within his own taxable income under Section 22(a) of the Internal Revenue Code, 26 U.S.C.A. § 22(a)....

Petitioner relies largely upon our decision in *Funk* v. *Commissioner*, 3 Cir., 185 F.2d 127, 131. There, the taxpayer was given the authority in her discretion to pay all or part of the trust income to her husband or herself in accordance with their "needs," of which she was to be the sole judge with the balance of the income, if any, to be added to principal. We held, in Judge Kalodner's fine opinion, 185 F.2d at page 131, that the use of the words "needs" effectively distinguished the case from the *Stix* and *Mallinckrodt* opinions, *supra*, and " . . . confined the trustee to limits objectively determinable, and any conduct on her part beyond those limits would be unreasonable and a breach of trust, ..." Also in *Funk*, if there were no need of the taxpayer or her husband for all or part of the trust income, that income did not go to the taxpayer as in the matter before us, but to the principal of the trust. Plainly, the *Funk* decision is inapplicable to the instant problem where there is no circumscription of the petitioner's discretion; where he has no obligation under Article Second to make any of the kind of payments referred to in the trust and where if he does not make such payments, the income, less payments to his sister, is his own.

The above conclusion is not contrary to Pennsylvania law. It is, in fact, fortified by a line of opinions cited to us by petitioner, in each of which, though the charitable beneficiaries were not specified by name, the extent of the charitable gift was either certain, or as Judge Kalodner said in the *Funk* case, was "objectively determinable." Thus what was to go to charity in *Re Anderson's Estate*, 269 Pa. 535, 537, 112 A.766, was "said residue" of testator's estate; in *Re Thompson's Estate*, 282 Pa. 30, 32, 127 A. 446, 447, it was "All the rest, residue and remainder of my estate, real and personal . . ."; in *Re Jordan's Estate*, 329 Pa. 427, 428, 197 A. 150, it was "a certain part" of her estate; in *Re Funk Estate*, 353 Pa. 321, 322, 45 A.2d 67, 68, 163 A.L.R. 780, after certain legacies, it was "After all debts the rest" to be given to some worthy cause or institution. Here we have no such situation. Nor was there present in any of those cases cited by the taxpayer the other all important element of the matter before us, namely, that in the event petitioner did not designate charities or benevolences as detailed in the agreement and direct payments to them, the income went to him.

Petitioner also argues that a constructive trust should be imposed under the particular facts. This is based, primarily, upon certain statements with respect to the trust made to petitioner by his father and agreed to by petitioner. The testimony of the petitioner concerning these was accepted by the Tax Court. The son testified that the father told him that "He wanted me to carry on his

charities.... He wanted his current charities carried on and he wanted the family tradition of giving to be continued." Petitioner testified that he promised to carry out the desires that his father indicated. He also stated that his father never expressed in any way a limitation as to the amount of the income from the trust which should go to charities as a whole.

The Tax Court was unable to find in those statements ". . . a purpose to create a charitable fund which the petitioner was legally bound to distribute for charitable purposes." We must agree with that finding. As the Tax Court held, "Neither the trust instrument nor any direction by the grantor has provided for the use of any specific amount of income for any particular charity or even for charity in general." Unquestionably, the donor desired the family tradition of giving carried on and he did make it possible for his son to do this in his own right. But we do not think that either the facts or the law go any further than that. . . .

The next point urged by petitioner is that the Tax Court erred in disregarding the construction placed on the deed of trust by the Orphans' Court of Allegheny County, Pennsylvania, in the audit proceedings held on the final accounting of the trustee of the 1927 trust.

After the death of the trustee, Maurice Falk, his final account as trustee under the deed of trust here involved was filed in the Allegheny County Orphans' Court. An order of that Court in that proceeding, dated September 18, 1946, stated that the petitioner

> is required to exercise a reasonable, fair and legal discretion in carrying out the provisions of the said Section 2 of Article Second of the said deed of trust and his exercise of such discretion is subject to supervision and review by this court.

The order also stated that the deceased trustee

> was required to exercise reasonable care to assure the proper performance by the said Leon Falk Jr., of the latter's duties under the said Section 2 of Article Second of said deed of trust.

The order appointed Arthur W. Scully trustee ad litem to represent the interests of all charitable, benevolent and educational institutions under the provisions of the deed of trust at the audit of such account. The Maurice Falk account on which the above order was based was filed *after* the Commissioner had questioned the taxability of the distributions by petitioner to charitable and educational institutions. The Commissioner was not a party to the accounting. The Tax Court held that there was no evidence that the Orphans' Court

> was advised that a construction of the trust instrument contrary to that set out in the decree had been made by the Government and a substantial tax liability proposed against the petitioner on the basis of such construction.

The Tax Court also found, and the finding is not questioned, that

> Although the petition for the appointment of a trustee ad litem and the order of the court are separate documents, it is clear that the decree was prepared together with the application for appointment.

The Tax Court held that the Orphans' Court accounting

> was not an adverse proceeding and the construction of the trust recited in the order appointing the trustee is not binding upon us in the determination of the petitioner's tax liability with respect to the income of the trust.

The record abundantly supports this conclusion of the Tax Court. *Cf. Loggie* v. *Thomas*, 5 Cir., 152 F.2d 636; *Thomas Flexible Coupling Co.* v. *Commissioner*, 3

Cir., 158 F.2d 828, certiorari denied 329 U.S. 810, 67 S. Ct. 624, 91 L. Ed. 691. The fact that it was not an adverse proceeding highlights the basic proposition that this is a question of federal income tax law. Under the circumstances here present, the county orphans' court cannot, as Mr. Justice Black said in *Commissioner* v. *Tower*, 327 U.S. 280, 288, 66 S. Ct. 532, 536, 90 L. Ed. 670, ". . . decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax levied against earned income."

There is no merit in petitioner's final point and it need not be discussed.

The decision of the Tax Court will be affirmed.

Note

1. As the case indicates, the 1939 Code contained no specified statutory provision governing this area, and the income was taxed to the petitioner under the general language of § 22(a) (now § 61(a) of the 1954 Code). At the same time that the *Clifford* regulation was issued, regulations were issued by the Treasury to cover this area also. Regs. 118, Sec. 39.22(a)-22.

2. The 1954 Code provides a statutory rule for taxing the income to a person other than the grantor; see § 678, and note § 678(d). Section 671 provides, as it does for grantors of trusts, that no other person shall be taxed under the general language of § 61 "solely on the grounds of his dominion and control over the trust." Could the husband be taxed on the income of a trust like that involved in the *Clifford* case if the funds were supplied by some other member of the family (*e.g.*, his father-in-law) or by a generous friend?

3. On the final point discussed in the *Falk* case, see Cardozo, "Federal Taxes and the Radiating Potencies of State Court Decisions," 51 *Yale L J.* 783 (1942).

FUNK v. COMMISSIONER

U. S. Court of Appeals, Third Circuit, 1950
185 F.2d 127

Before BIGGS, Chief Judge, and KALODNER and HASTIE, Circuit Judges.

KALODNER, Circuit Judge.

The only substantial issue presented on this petition to review the decision of the Tax Court is whether there is taxable to the taxpayer under Section 22(a) of the Internal Revenue Code, 26 U.S.C.A. Section 22(a), the income of four trusts of which she was the sole trustee in the taxable years 1938 to 1941 here involved. The trusts were created by the taxpayer's husband.

The Tax Court, four judges dissenting, held that the income of the trusts, without regard to the distributions made by the taxpayer, is taxable to her. 14 T.C. 198.

The details of the creation of the trusts in controversy are set out in our prior decision in this matter, 3 Cir., 163 F.2d 796, as a result of which the cause was remanded to the Tax Court. In its decision now under review, the Tax Court has again set forth in detail its findings concerning the creation of the trusts. We shall not repeat them here. It is sufficient to state that under the terms of four trusts, which in this respect were identical, the taxpayer, as trustee, was given the authority

. . . in her discretion to pay all or a part of the net income annually to me (her husband, the settlor), or to herself, in accordance with our respective needs, of which she shall be the sole judge, and to accumulate and add to principal the balance of such income,

if any. Any income so accumulated and added to principal by the Trustee shall become a part of the corpus of the trust and may not thereafter be distributed by the Trustee.

Upon the death of the settlor-beneficiary, the corpus of each trust was to be distributed as he should appoint, but in default thereof, contingent beneficiaries were specified. The taxpayer and her husband were at all relevant times residents of New Jersey, where the trusts were created and administered.

The Commissioner, throughout this litigation, has contended that while the taxpayer was given control over the income of the trusts as trustee, nevertheless her control was "too little fettered to be regarded as less than absolute for tax purposes." Accordingly, he seeks to tax to her all of the income of the trusts, without regard to the manner of distribution, upon the example of *Mallinckrodt* v. *Nunan*, 8 Cir., 1945, 146 F.2d 1, certiorari denied, 324 U.S. 871, and *Stix* v. *Commissioner*, 2 Cir., 1945, 152 F.2d 562.

The Tax Court determined that the taxpayer had

absolute control over the trusts' income, that she made distributions entirely by the exercise of her own discretion; that she took whatever she wanted each year, and gave some of the rest to her husband in certain years; that what she distributed to him was determined solely by herself without any consideration of whether or not he had any need for the income, that the petitioner's (taxpayer's) husband had no need for any of the distributions which she made to him in 1939, 1940, and 1941, and that the sums which she did distribute to him were "gifts." [1]

It then concluded that the evidence showed that the taxpayer, as trustee

followed to the letter the provisions in the trust instruments that she should distribute the trust income in her discretion, and that she should be the "sole judge" of how she would distribute the income.

Thus, the Tax Court agreed with the Commissioner that the quoted clause in the trust instruments gave the taxpayer such unfettered command of the income therefrom as to bring her within the bounds of the *Mallinckrodt* and *Stix* cases. It held, too, after the manner of the *Stix* case, that the taxpayer had not shown what amount of the trusts' income she would have been compelled to pay to her husband, qua beneficiary, and hence, she had not proved what amount of the income was not within her absolute control.

It is our view that the Tax Court erred. But for the purpose of disposing of the instant petition of review we need not disagree on any principle of tax law. As the Tax Court recognized, the issue here turns on the provisions in the trust instruments relating to the power of the taxpayer-trustee over the income of the trusts. The Commissioner, likewise, rests upon the contention, that within the framework of the trusts, the income, for all practical purposes, was the taxpayer's own money.

The approach of the Commissioner to the problem presented is somewhat different from that of the Tax Court. He emphasizes the phrase "respective needs," and seeks to persuade that the word "needs," particularly coupled with the trustee's

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[1] In its statement, "Findings of Fact," the Tax Court also determined that in making distributions for the taxable years 1938 through 1941, the taxpayer, as trustee, did not make the respective distributions to herself and to her husband upon the basis of the needs of either one of them It also found that the taxpayer's opinion was that neither she nor her husband had any need for any part of the income of the trusts in the taxable years because both had their own separate and independent income of substantial proportions. Finally, it found that taxpayer "took what money she wanted, if any, for her personal use, or to satisfy some desire to be extravagant, and gave her husband whatever was left, or whatever sum she wished to give him."

investiture as "sole judge" in respect thereto, is and was intended by the settlor to be, a nebulous standard not unlike that discussed in the *Stix* decision. Consequently, the Commissioner asserts that the trusts' income must be taxed to the taxpayer unless she proved the amount which a court of equity would require her to pay to her husband-beneficiary.

The Tax Court, on the other hand, starts with the conclusion that there is no ambiguity in the trust instrument insofar as here pertinent and, whatever the motive of the settlor, the unambiguous and specific language controls.[2] *Bunting* v. *Commissioner of Internal Revenue*, 6 Cir., 1947, 164 F.2d 443, certiorari denied 333 U.S. 856, 68 S. Ct. 735, 92 L. Ed. 1136. The construction which the Tax Court put upon the language of the trusts here in issue is exemplified by its determination, to which we have alluded, that the taxpayer, as trustee,

> followed to the letter the provisions . . . that she should distribute the trust income in her discretion, and that she should be the "sole judge" of how she would distribute the income.

However, the tautological holding that the trustee's endowed authority was to distribute in her discretion and to be the sole judge of how she would distribute omits the critical, mandatory directions given by the settlor. First, the distribution, hence the exercise of discretion, must relate exclusively to the beneficiaries' respective needs, of which the trustee is the sole judge; and second, what is not needed must be accumulated and added to the principal, in which event the trustee is deprived of any authority to distribute.

Re-inserting, as we cannot avoid, these important commands in the trust indentures, we are impelled to the conclusion that the trustee was not clothed with either the power or right to enjoy the trust income at her option, that is, unless the word "needs" be construed in such fashion as to permit it, a point which we shall shortly reach. The authorization to the trustee to act as the "sole judge" did not convey the trust income to her alone. To the contrary, only upon a determination of "needs," however that term may be defined, was she authorized to exercise her discretion in the matter of distributions. Patently, she would not be permitted to apply one definition of the word "needs" to her co-beneficiary and at the same time another more indulgent definition to herself, qua beneficiary. For it has been specifically held in New Jersey that a trustee-beneficiary cannot use his fiduciary capacity to prefer himself, and that where the trustee is a beneficiary his conduct will be scrutinized and weighed in the ultimate determination of the issue of the propriety of his exercise of discretion. Nor does it follow, when the settlor lays down a standard, here "respective needs," that the designation of the trustee as "sole judge," or even the grant to him of "absolute discretion," obviates the necessity of exercising his judgment in a sound and honest manner, or relieves him of the duty to act in good faith and with a proper motive within the reasonable boundaries of such standard. Thus, if the trustee here neglected or refused to make a

[2] If the empowering clauses of the trusts are clear and unambiguous, it would follow that the evidence of the settlor's intent and of the trustee's conduct would not be admissible in New Jersey, Central Hanover B. & T Co. v. Herbert, 1949, 1 N.J. 426, 429, 64 A.2d 75, 76· "The rule is that parol evidence is admissible to explain an ambiguity in a writing, or when the intent of the donor is not clear But where the language employed has an ordinary meaning or where the meaning is plain and unambiguous on its face, there is no ground for the application of the above rule and parol or extrinsic evidence is inadmissible."

sound determination of needs, or even honestly believed that there were no needs, and acted upon the extravagance of whim and caprice, made her own desires to predominate, and distributed any part of the trusts' income as a gift, then we should think such brazen abuse of her fiduciary obligations under the terms of the trusts here involved would be universally condemned. *Restatement, Trusts,* Section 187; 2 *Scott on Trusts* (1939) Section 187.

Since the single question in the case *sub judice* turns upon the provisions of the trust instruments, the trustee's actual conduct cannot be confused with her authorized powers. The Commissioner is not now asserting, nor did the Tax Court hold, that the trustee is taxable because she treated the trust income as her own regardless of her right to do so. The very minimum of difference between this and the *Mallinckrodt, Stix* and kindred cases, at once becomes apparent. In those two cases, the taxpayers had for their own undesignated use the primary right to, and the command of, the income involved. There was no duty to relinquish except to provide for others what they might consider proper; hence, the determination that the taxpayers should have shown what they could be required to distribute. Here, the trustee had no *a fortiori* right to the income, nor did the absence of any "needs" on the part of either her co-beneficiary or herself confer such right upon her. What was not needed was directed by the settlor to be accumulated and added to principal, and the trustee's discretionary power to distribute conclusively terminated. She did not even have the authority to invade the principal in the event the income proved inadequate. On the basis of the decisions already cited, it seems, therefore, beyond dispute that if the taxpayer, as the Tax Court found, was of the opinion that neither she nor her husband had any needs, however she defined that term, yet made distributions to her husband and herself, she was patently acting outside the scope of the authority conferred upon her as trustee and in violation of the confidence reposed in her.

Further, we should point out, as we once did,[3] that the fact that the taxpayer's husband, as a beneficiary, might not be in a position to compel payments to himself is not determinative of his standing to compel the trustee to accumulate, or at least to prevent her arbitrary administration of the trusts, whether for her own advantage or not. In point of law, it is not alone for him to complain, for clearly the contingent beneficiaries have a position in any proceeding involving the discharge by the trustee of her fiduciary duties, and so, too, successor or substituted trustees may maintain an action to redress a breach of trust particularly if it constitutes an appropriation of trust property.

In view of the foregoing, it must be apparent that in the final analysis the primary source of difficulty in this case, as the Commissioner contends, concerns the meaning of the word "needs." The Commissioner says that the term means, and was intended by the settlor * to mean, the equivalent of "desires," and that under the trust instruments the trustee was obliged only to distribute the income as she thought "fit" or "proper." The argument is based upon the determination that the taxpayer and her husband, qua beneficiaries, were in the taxable years independently wealthy and had no "needs" in the sense of necessities of life. The

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[3] 163 F.2d 796, 803.

* The settlor was president of Funk & Wagnalls Co., whose New Standard Dictionary of the English Language (1945) defines "need" as follows: "*need*, n. 1. A lack of something necessary or very desirable, want; hence, destitution or deprivation, especially of the necessaries of life; indigence; poverty; as, the poor man was in great need." [Ed.]

intention of the settlor, in addition, is culled by the Commissioner from an exchange of letters between the settlor and his wife at the time of the creation of the trusts,† as well as from the failure of the settlor to take any action to correct his wife if in fact she were conducting herself as trustee contrary to his design and the declarations in the trusts.

The term "needs" is not, of course, one the content of which can be defined precisely. Nevertheless, we think it establishes a standard effectively distinguishing this case from, and taking it out of the rule of, the *Mallinckrodt* and *Stix* decisions. If, as the Tax Court observed, the trusts are unambiguous and specific, it can only be said of the term "needs" that it must be construed according to its ordinary meaning. While obviously it must include the essentials of life, it has been construed in New Jersey to mean that which is reasonably necessary to maintain a beneficiary's station in life. It is not indicative of an unqualified gift, nor is it dependent upon the fancy of the administrator. Thus, its use confined the trustee to limits objectively determinable, and any conduct on her part beyond those limits would be unreasonable and a breach of trust; certainly it did not countenance extravagance, whim, or caprice. And, as we have already noted, the absence of "needs," contrary to the situation of Mallinckrodt and Stix, did not result in the entitlement of the taxpayer to the trust income.

Assuming that the letters were admissible nothing in them demonstrates an intent on the part of the settlor, or even an understanding on the part of the trustee, to incorporate into the word "needs" something other than its common sense content. Indeed, the settlor's letter suggests the correctness of the result we have reached. True, he emphasizes therein the independence of the trustee from control by himself of any other person.[4] But he refers to the trustee's "discretion,"

† The letters, quoted in the Tax Court's opinion, 14 T.C. 198, 205n, were as follows [Ed]

Letter of Wilfred J. Funk to Eleanor M. Funk

"Dear Eleanor. As you know, I have to-day made you the Trustee of four trusts designated as Trusts A, B, C, and D, the property transferred to each trust consisting of 125 shares of the capital stock of Erwin Park, Inc. Under the terms of these trusts you are to have discretion annually to divide the income between us or to accumulate and add it to the principal of the trust

"My objective in setting up the trusts in this way is to provide substantial amounts of income which you may dispose of according to the circumstances which you find to exist at the end of each year. No one can foretell with certainty what those circumstances will be, and it is my desire to put you in a position to exercise your own judgment as to how such circumstances shall be met, to the extent of the income arising from these trust funds

"It is your legal right and duty to exercise this discretion each year as may seem best to you, and in the exercise of this discretion you are not subject to my control or to the control of any other person."

Letter of Eleanor M. Funk to Wilfred J. Funk·

"Dear Wilfred: I have read your letter of to-day with reference to the four new trusts which you are setting up, of which you have made me Trustee.

"I understand that at the end of each year I am to decide whether I will pay the income which I have received as Trustee to you or to myself or divide it between us or accumulate and add it to principal I am to do any or all of these things in such amounts and in such proportion as I see fit.

"I understand that the effect of these trusts is to place upon me the duty of deciding how the money shall be disposed of and that in making this decision I am not subject to your control or that of any other person."

[4] Patently, the purpose of the settlor was to avoid finding himself within the doctrine of Helvering v. Clifford, 1940, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, and the Tax Court has determined him to have successfully achieved this aim: Wilfred J. Funk, decided February 7, 1944.

states that she is to act upon the circumstances which she finds to exist at the end of each year, and declares it his intention to put her in a position where she can exercise her own judgment as to how the circumstances should be met. Thus, the settlor has conveyed, as clearly as one might wish, his intent that the trustee should investigate and judge. His letter is inconsistent with any notion that she may act arbitrarily or capriciously. And the mandate of the trusts to accumulate, without right of re-entry by the trustee, lends weight to the conclusion that the settlor's state of mind did not encompass the thought that his wife should become the practical owner of the trusts' income. Similarly, her response to his letter emphasizes her independence of decision. It accepts the responsibility of administering the trusts and expressly acknowledges a duty with respect thereto. It is not a detailed attempt to state her understanding of her obligations, but it does not deny any of the terms of the trusts. If she has not acted since then within the scope of her fiduciary duties, it is not inferable from the mere failure of her husband to complain in the taxable years that she was therefore acting within the scope of those duties. We should not speculate upon the reasons for his failure to act, but, as we have pointed out, others may still do so.

We conclude, therefore, that the taxpayer was not endowed in the trust instruments with such unfettered command that the income therefrom became, for all intents and purposes, her own money. Accordingly, the decision of the Tax Court will be reversed.

Note

Since it was possible for the income to be distributed to the husband, who created the trusts, was it taxable to him? See again § 677(a)(2) and Regs. 118, Sec. 39.167-1. In a related case, *Funk* v. *Commissioner*, ¶ 44,030 P-H Memo TC (1944), referred to in footnote 4 of the principal case, it was held that the husband was not taxable under the *Clifford* case·

> Here Mrs. Funk was not only trustee but she was an income beneficiary under all four trust instruments. When she made payments to petitioner there remained just that much less for herself It can not be gain-said that her interest in the income was adverse to petitioner. . . . In New Jersey the courts will not substitute their judgment for that of a trustee where discretion is given the trustee, even at the behest of a beneficiary not the grantor, except upon proof that the exercise of the discretion has been in bad faith. . . . In view of the New Jersey law, it is inconceivable that this petitioner, having voluntarily placed such obviously broad discretionary powers in another and having no real need for the trust income during the taxable years, could successfully complain had the trustee elected to pay him no income.

See Note, 60 *Yale L.J.* 1426 (1951).

3. *Family Partnerships*

> *Note:* **Sections 191 and 3797(a)(2) of the 1939 Code, relating to family partnerships, which were enacted in 1951, were taken over without change by § 704(e) of the 1954 Code.**

Unlike the trust, the partnership is not a separate taxable entity. A partnership return must be filed for the Treasury's information, reporting all partnership income and deductions, but the firm's net income is taxed to the partners individually, whether withdrawn or not, in accordance with their respective interests. Sections

701–704. Losses of the firm are similarly allocated among the partners and deducted by them on their individual returns. The 1954 Code allows certain partnerships to be taxed, if they so elect, as corporations. See *infra*, Ch. 7, Section B.

With the decline of the trust as a tax avoidance device came, fortuitously or not, the rise of the "family partnership" as a means of splitting income. Typically, the head of the family, doing business as an individual proprietor, would create a partnership by transferring by gift portions of his business capital to his wife and children, and by agreeing that thereafter the income of the enterprise would be distributed among the partners in an agreed proportion, usually according to their interests in the firm's capital. Ordinarily the new partners took no part in the management of the firm, though occasionally they served in clerical or other minor capacities. Sometimes the donor would reserve a "salary" for his own services, to be deducted before the profits accruing to capital were calculated. The high water mark in this area is *Tinkoff* v. *Commissioner*, 120 F.2d 564 (7th Cir. 1941), involving an accountant who took his son into his accounting firm as a partner on the day the boy was born.

The Supreme Court's first direct sally into this field was in 1946, when *Commissioner* v. *Tower*, 327 U.S. 280, and *Lusthaus* v. *Commissioner*, *id.* 293, were decided. Although the lower courts could easily discern which way the wind was blowing, they were unsure of its velocity. The Supreme Court then tried again.

COMMISSIONER v. CULBERTSON

Supreme Court of the U. S., 1949

337 U.S. 733

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

This case requires our further consideration of the family partnership problem. The Commissioner of Internal Revenue ruled that the entire income from a partnership allegedly entered into by respondent and his four sons must be taxed to respondent, and the Tax Court sustained that determination. The Court of Appeals for the Fifth Circuit reversed. 168 F.2d 979. We granted certiorari, 335 U.S. 883, 69 S. Ct. 235, to consider the Commissioner's claim that the principles of *Commissioner* v. *Tower*, 1946, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135, and *Lusthaus* v. *Commissioner*, 1946, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679, have been departed from in this and other courts of appeals decisions.

Respondent taxpayer is a rancher. From 1915 until October 1939, he had operated a cattle business in partnership with R. S. Coon. Coon, who had numerous business interests in the Southwest and had largely financed the partnership, was 79 years old in 1939 and desired to dissolve the partnership because of ill health. To that end, the bulk of the partnership herd was sold until, in October of that year, only about 1,500 head remained. These cattle were all registered Herefords, the brood or foundation herd. Culbertson wished to keep these cattle and approached Coon with an offer of $65 a head. Coon agreed to sell at that price, but only upon condition that Culbertson would sell an undivided one-half interest in the herd to his four sons at the same price. His reasons for imposing this condition were his intense interest in maintaining the Hereford strain which he and Culbertson had developed, his conviction that Culbertson was too old to

carry on the work alone, and his personal interest in the Culbertson boys. Culbertson's sons were enthusiastic about the proposition, so respondent thereupon bought the remaining cattle from the Coon and Culbertson partnership for $99,440. Two days later Culbertson sold an undivided one-half interest to the four boys, and the following day they gave their father a note for $49,720 at 4 per cent interest due one year from date. Several months later a new note for $57,674 was executed by the boys to replace the earlier note. The increase in amount covered the purchase by Culbertson and his sons of other properties formerly owned by Coon and Culbertson. This note was paid by the boys in the following manner:

Credit for overcharge .	$ 5,930
Gifts from respondent .	21,744
One-half of a loan procured by Culbertson & Sons partnership	30,000

The loan was repaid from the proceeds from operation of the ranch.

The partnership agreement between taxpayer and his sons was oral. The local paper announced the dissolution of the Coon and Culbertson partnership and the continuation of the business by respondent and his boys under the name of Culbertson & Sons. A bank account was opened in this name, upon which taxpayer, his four sons and a bookkeeper could check. At the time of formation of the new partnership, Culbertson's oldest son was 24 years old, married, and living on the ranch, of which he had for two years been foreman under the Coon and Culbertson partnership. He was a college graduate and received $100 a month plus board and lodging for himself and his wife both before and after formation of Culbertson & Sons and until entering the Army. The second son was 22 years old, was married and finished college in 1940, the first year during which the new partnership operated. He went directly into the Army following graduation and rendered no services to the partnership. The two younger sons who were 18 and 16 years old respectively in 1940, went to school during the winter and worked on the ranch during the summer.

The tax years here involved are 1940 and 1941. A partnership return was filed for both years indicating a division of income approximating the capital attributed to each partner. It is the disallowance of this division of the income from the ranch that brings this case into the courts.

First. The Tax Court read our decisions in *Commissioner* v. *Tower*, *supra*, and *Lusthaus* v. *Commissioner*, *supra*, as setting out two essential tests of partnership for income-tax purposes: that each partner contribute to the partnership either vital services or capital orignating with him. Its decision was based upon a finding that none of respondent's sons had satisfied those requirements during the tax years in question. Sanction for the use of these "tests" of partnership is sought in this paragraph from our opinion in the *Tower* case:

> There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner as contemplated by 26 U.S.C. §§ 181, 182, 26 U.S.C.A. §§ 181, 182. The Tax Court has recognized that under such circumstances the income belongs to the wife. A wife may become a general or a limited partner with her husband. But when she does not share in the management and control of the business, contributes no vital additional

service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws. (327 U.S. at page 290, 66 S. Ct. at page 537, 90 L. Ed. 670, 164 A.L.R. 1135.)

It is the Commissioner's contention that the Tax Court's decision can and should be reinstated upon the mere reaffirmation of the quoted paragraph.

The Court of Appeals, on the other hand, was of the opinion that a family partnership entered into without thought of tax avoidance should be given recognition taxwise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contributions, since it was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership." We must consider, therefore, whether an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case. The sections of the Internal Revenue Code involved are §§ 181 and 182, which set out the method of taxing partnership income, and §§ 11 and 22(a), which relate to the taxation of individual incomes.*

In the *Tower* case we held that despite the claimed partnership, the evidence fully justified the Tax Court's holding that the husband, through his ownership of the capital and his management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under §§ 11 and 22(a). In such case, other members of the partnership cannot be considered "Individuals carrying on business in partnership" and thus "liable for income tax . . . in their individual capacity" within the meaning of § 181. If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years.[1] The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it. *Lucas* v. *Earl*, 1930, 281 U.S. 111, 50 S Ct. 241, 74 L. Ed. 731; *Helvering* v. *Clifford*, 1940, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788; *National Carbide Corp.* v. *Commissioner*, 1949, 336 U.S. 422, 69 S. Ct. 726.

Furthermore, our decision in *Commissioner* v. *Tower*, *supra*, clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." This is, after all, but the application of an often iterated definition of income—the gain

* Section 191 of the 1939 Code (§ 704(e) of the 1954 Code), relating specifically to family partnerships, was not enacted until 1951 [Ed.]

[1] Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

derived from capital, from labor, or from both combined—to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services. *Ward* v. *Thompson*, 1859, 22 How. 330, 334, 16 L. Ed. 249. The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.

Second. We turn next to a consideration of the Tax Court's approach to the family partnership problem. It treated as essential to membership in a family partnership for tax purposes the contribution of either "vital services" or "original capital." Use of these "tests" of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, "whether the partnership is real within the meaning of the federal revenue laws" and makes decisive what we described as "circumstances [to be taken] into consideration" in making that determination.

The *Tower* case thus provides no support for such an approach. We there said that the question whether the family partnership is real for income-tax purposes depends upon

> whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions." *Drennen* v. *London Assurance Co.*, 113 U.S. 51, 56, 5 S. Ct. 341 [343], 344, 28 L. Ed. 919, *Cox* v. *Hickman*, 8 H.L. Cas. 268. We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. (327 U.S. at page 287, 66 S. Ct., at page 536, 90 L. Ed. 670, 164 A.L.R. 1135.)

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[2] There is nothing new or particularly difficult about

[2] This is not, as we understand it, contrary to the approach taken by the Bureau of Internal Revenue in its most recent statement of policy. I.T. 3845, 1947 Cum. Bull. 66, states at p. 67:

"Where persons who are closely related by blood or marriage enter into an agreement purporting to create a so-called family partnership or other arrangement with respect to the operation of a business or income-producing venture, under which agreement all of the parties are accorded substantially the same treatment and consideration with respect to their designated interests and prescribed responsibilities in the business as if they were strangers dealing at arm's length; where the actions of the parties as legally responsible persons evidence an intent to carry on a business in a partnership relation; and where the terms of such agreement are substantially followed in the operation of the business or venture, as well as in the dealings of the partners or members with each other, it is the policy of the Bureau to disregard

such a test. Triers of fact are constantly called upon to determine the intent with which a person acted.[3] The Tax Court, for example, must make such a determination in every estate tax case in which it is contended that a transfer was made in contemplation of death, for "The question, necessarily, is as to the state of mind of the donor." *United States* v. *Wells*, 1931, 283 U.S. 102, 117, 51 S. Ct. 446, 451, 75 L. Ed. 867. See *Allen* v. *Trust Co. of Georgia*, 1946, 326 U.S. 630, 66 S. Ct. 389, 90 L. Ed. 367. Whether the parties really intended to carry on business as partners is not, we think, any more difficult of determination or the manifestations of such intent any less perceptible than is ordinarily true of inquiries into the subjective.

But the Tax Court did not view the question as one concerning the bona fide intent of the parties to join together as partners. Not once in its opinion is there even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services "for the purpose of carrying on the business." Instead the court, focusing entirely upon concepts of "vital services" and "original capital," simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the *Tower* case. The court's opinion is replete with such statements as

> we discern nothing constituting what we think is a requisite contribution to a real partnership. . . . We find no son adding "vital additional service" which would take the place of capital contributed because of formation of a partnership . . . it is clear that the sons made no capital contribution within the meaning of the *Tower* case.[4]

Unquestionably a court's determination that the services contributed by a partner are not "vital" and that he has not participated in "management and control of the business" or contributed "original capital" has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive, and that is the vice in the "tests" adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be

the close family relationship existing between the parties and to recognize, for Federal income tax purposes, the division of profits prescribed by such agreement However, where the instrument purporting to create the family partnership expressly provides that the wife or child or other member of the family shall not be required to participate in the management of the business, or is merely silent on that point, the extent and nature of the services of such individual in the actual conduct of the business will be given appropriate evidentiary weight as to the question of intent to carry on the business as partners."

[3] Nearly three-quarters of a century ago, Bowen, L. J., made the classic statement that "the state of a man's mind is as much a fact as the state of his digestion." Edgington v. Fitzmaurice, 29 L. R.Ch Div. 459, 483. State of mind has always been determinative of the question whether a partnership has been formed as between the parties. See, e.g, Drennen v London Assurance Co., 1884, 113 U S. 51, 56, 5 S. Ct. 341, 343, 28 L. Ed. 919, Meehan v. Valentine, 1892, 145 U.S. 611, 621, 12 S Ct. 972, 974, 36 L. Ed. 835; Barker v Kraft, 1932, 259 Mich. 70, 242 N W. 841; Zuback v. Bakmaz, 1943, 346 Pa. 279, 29 A 2d 473; Kennedy v. Mullins, 1930, 155 Va 166, 154 S.E. 568

[4] In the *Tower* case the taxpayer argued that he had a right to reduce his taxes by any legal means, to which this Court agreed. We said, however, that existence of a tax avoidance motive gives some indication that there was no bona fide intent to carry on business as a partnership If Tower had set up objective requirements of membership in a family partnership, such as "vital services" and "original capital," the motives behind adoption of the partnership form would have been irrelevant.

contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The *Tower* case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent. Even though it was admitted in the *Tower* case that the wife contributed no original capital, management of the business, or other vital services, this Court did not say as a matter of law that there was no valid partnership. We said, instead, that "There was, thus, more than ample evidence to support the Tax Court's finding that no genuine union for partnership purposes *was ever intended*, and that the husband earned the income." 327 U.S. at page 292, 66 S. Ct. at page 538, 90 L. Ed. 670, 164 A.L.R. 1135. (Italics added.)

Third. The Tax Court's isolation of "original capital" as an essential of membership in a family partnership also indicates an erroneous reading of the *Tower* opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in *Helvering* v. *Clifford, supra.* The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes. In the *Tower* and *Lusthaus* cases this Court, applying the principles of *Lucas* v. *Earl, supra*, *Helvering* v. *Clifford, supra*; and *Helvering* v. *Horst, supra*; 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655, found that the purported gift, whether or not technically complete, had made no substantial change in the economic relation of members of the family to the income. In each case the husband continued to manage and control the business as before, and income from the property given to the wife and invested by her in the partnership continued to be used in the business or expended for family purposes. We characterized the results of the transactions entered into between husband and wife as "a mere paper reallocation among the family members," noting that "The actualities of their relation to the income did not change." This, we thought, provided ample grounds for the finding that no true partnership was intended; that the husband was still the true earner of the income.

But application of the *Clifford-Horst* principle does not follow automatically upon a gift to a member of one's family, followed by its investment in the family partnership. If it did, it would be necessary to define "family" and to set precise limits of membership therein. We have not done so for the obvious reason that existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem. It is frequently stated that transactions between members of a family will be carefully scrutinized. But more particularly, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. He is able, in other words, to retain "the substance of full enjoyment of all the rights which previously he had in the property." *Helvering* v. *Clifford, supra*, 309 U.S. at page 336, 60 S. Ct. at page 557, 75 L. Ed. 731.[5]

[5] It is not enough to say in this case, as we did in the *Clifford* case, that "It is hard to imagine that respondent felt himself the poorer after this [partnership agreement] had been executed or,

The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. The *Tower* case recognized that one's participation in control and management of the business is a circumstance indicating an intent to be a bona fide partner despite the fact that the capital contributed originated elsewhere in the family.[6] If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. In the *Tower* and *Lusthaus* cases we distinguished between active participation in the affairs of the business by a donee of a share in the partnership on the one hand, and his passive acquiescence to the will of the donor on the other. This distinction is of obvious importance to a determination of the true intent of the parties. It is meaningless if "original capital" is an essential test of membership in a family partnership.

The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the *Clifford*, *Horst*, and *Tower* cases? No question as to the allocation of income between capital and services is presented in this case, and we intimate no opinion on that subject.

The decision of the Court of Appeals is reversed with directions to remand the cause to the Tax Court for further proceedings in conformity with this opinion.

Reversed and remanded.

MR. JUSTICE BLACK and MR. JUSTICE RUTLEDGE think that the Tax Court properly applied the principles of the *Tower* and *Lusthaus decisions*, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679, in this case. However, they consider it of paramount importance in this case to have a court interpretation of the applicable taxing statute, for guidance in its application. Accordingly, they acquiesce in the Court's opinion and judgment.

MR. JUSTICE BURTON, concurring, states that, upon remand of the cause to the

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if he did, that it had any rational foundation in fact." 309 U S. at page 336, 60 S Ct at page 557, 74 L. Ed. 731. Culbertson's interest in his partnership with Coon was worth about $50,000 immediately prior to dissolution of the partnership. In order to sustain the Tax Court, we would have to conclude that he felt himself worth approximately twice that much upon his purchase of Coon's interest, even though he had agreed to sell that interest to his sons at the same price.

[6] As noted above (note 4), participation in control and management of the business, although given equal prominence with contributions of "vital services" and "original capital" as circumstances indicating an intent to enter into a partnership relation, was discarded by the Tax Court as a "test" of partnership. This indicates a basic and erroneous assumption that one can never make a gift to a member of one's family without retaining the essentials of ownership, if the gift is then invested in a family partnership We included participation in management and control of the business as a circumstance indicative of intent to carry on business as a partner to cover the situation in which active dominion and control of the subject of the gift had actually passed to the donee. It is a circumstance of prime importance.

Tax Court, there is nothing in the facts which have been presented here which, as a matter of law, will preclude that court from finding that the 1940 and 1941 income was properly taxable on a partnership basis. The physical absence of some of the Culbertson boys from the ranch does not necessarily preclude them or others from the obligations or the benefits of the partnership for tax purposes. Their contributions of capital, their participation in the income and their commitments to return to the ranch or otherwise to render service to the partnership are among the material factors to be considered. A present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as for other partnership purposes.

MR. JUSTICE JACKSON would affirm on the opinion of the court below, being of the view that the ordinary common-law tests of validity of partnerships are the tests for tax purposes and that they were met in this case.

MR. JUSTICE FRANKFURTER, concurring.

The Court finds that the Tax Court applied wrong legal standards in determining that the arrangement in controversy did not constitute a partnership. It remands the case to the Tax Court because it is for that court, and not for the Court of Appeals, to ascertain, on the basis of appropriate legal criteria, the existence of a partnership within the provisions of Int. Rev. Code, §§ 181 and 182, 26 U.S.C.A. §§ 181, 182. With these conclusions I agree. I think, however, that it is due to the Tax Court, the Courts of Appeals, the Treasury and the bar to make more explicit what the appropriate legal criteria are.

The Tax Court's decision rested on a misconception of our decision in *Commissioner* v. *Tower*, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135. It is, however, fair to say that it was led into that misconception by phrases which it culled from the *Tower* opinion with inadequate attention to the opinion in its entirety—both what it said and what it significantly did not say. The *Tower* opinion did not say what the Government now urges upon this Court; the Court's opinion did not take the position of the concurring opinion. In short, the opinion did not say that family partnerships are not to be regarded as partnerships for income-tax purposes even though they be genuine commercial partnerships; the opinion did not even announce hobbling presumptions under the income-tax law against such partnerships.

On the contrary, in defining the relevant considerations for determining the existence of a partnership, the Court in the *Tower* case relied on familiar decisions formulating the concept of partnership for purposes of various commercial situations in which the nature of that concept was decisive. It is significant that among the cases cited was the leading case of *Cox* v. *Hickman*, 8 H.L. Cas. 268. The Court today reaffirms this reliance by its quotation from the *Tower* case. The final sentence of the portion quoted underlines the fact that the Court did not purport to announce a special concept of "partnership" for tax purposes differing from the concept that rules in ordinary commercial-law cases. The sentence is:

> We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. 327 U.S. at page 287, 66 S. Ct. at page 535, 90 L. Ed. 670, 164 A.L.R. 1135. . . .

A fair reading of our *Tower* opinion in its entirety reflects the formulation of the concept of partnership which is set forth at the beginning of its analysis and which the Court now quotes. While recognizing the importance of the question "who actually owned a share of the capital attributed to the wife on the partnership books," the *Tower* opinion states the ultimate issue to be "whether this husband and wife really intended to carry on business as a partnership." 327 U.S. at page 289, 66 S. Ct. at page 537, 90 L. Ed. 670, 164 A.L.R. 1135. To that determination it was of course relevant that no new capital was brought into the business as a result of the formation of the partnership, that the wife drew on income of the partnership only to pay for the type of things she had previously bought for the family, and that the consequence was a mere paper reallocation of income. But these circumstances were not cited as giving the term "partnership" a content peculiar to the Internal Revenue Code. They were characterized, rather, simply as "more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended" and, as a corollary, "that the husband earned the income." 327 U.S. at page 292, 66 S. Ct. at page 538, 90 L. Ed. 670, 164 A.L.R. 1135.

Recognition of the importance, in applying §§ 181 and 182, of the appraisal of facts makes manifest why, quite apart from the definition contained in § 3797, a determination by a State court should not, as the *Tower* opinion pointed out, foreclose a contrary determination by a federal tribunal charged with administration of the tax laws. Such an inconsistency would not mean that the legal standards applied by each were inconsistent; it would be a result simply of the commonplace that no finder of fact can see through the eyes of any other finder of fact. See *Texas* v. *Florida*, 306 U.S. 398, 411, 59 S. Ct. 563, 570, 83 L. Ed. 817, 121 A.L.R. 1179. Nor would inconsistency be created by a State court's concern for the protection of creditors which lead it to seize upon adoption of the outward form as the vital fact. So, indeed, might the taxing authorities refuse to be precluded from holding the taxpayer to his election to adopt the form of a partnership. *Cf. Higgins* v. *Smith*, 308 U.S. 473, 477, 60 S. Ct. 355, 357, 84 L. Ed. 406. The need for guarding against misuse of the outward form of a partnership as a device for obtaining tax advantages is properly satisfied by reliance on the vigilance of the Tax Court, not by distorting the concept of partnership. It is not for this Court, by redefinition or the erection of presumptions, to amend the Internal Revenue Code so as virtually to ban partnerships composed of the members of an intimate family group.

The present case, nevertheless, is not the first manifestation of an impression that the *Tower* opinion had precisely such an effect. It seems to me important, therefore, to make crystal clear that there is no special concept of "partnership" for tax purposes, while at the same time recognizing that in view of the temptations to assume a virtue that they have not for the sake of tax savings, men and women may appear in a guise which the gimlet eye of the Tax Court is entitled to pierce. We should leave no doubt in the minds of the Tax Court, of the Courts of Appeals, of the Treasury and of the bar that the essential holding of the *Tower* case is that there is "no reason" why the "general rule" by which the existence of a partnership is determined "should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes."

In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of §§ 181 and 182. But if they are in the same business boat, although they may have varying rewards and varied responsibilities, they do not cease to be in it when the tax collector appears.

Note

1. On remand, the Tax Court found that the taxpayers did not intend in good faith to become partners. The Court relied in part on a statement made by the father to a creditor that he and his wife had reserved unrestricted control over the property until the sons reached their majority. Rather than assume that this document was invalid, and that the father was guilty of obtaining credit under false pretenses, the Court concluded that "it stated the real and true situation." Other facts inconsistent with a bona fide partnership were also found by the Court. *Culbertson* v. *Commissioner*, ¶ 50,187 P-H Memo TC. The Tax Court was again reversed by the Court of Appeals. As authority for the reversal, the Court of Appeals relied both on the Supreme Court's decision and on its own previous decision which had been reversed by the Supreme Court. The Court of Appeals found that the Tax Court had no more, and possibly less, evidence for its decision than it had had previously. The Court of Appeals also stated that the Supreme Court had misunderstood its "thoroughly considered and carefully reasoned opinion" and denied that "we held on the former opinion, hold now, or ever did hold to" the view attributed to it by the Supreme Court. *Culbertson* v. *Commissioner*, 194 F.2d 581 (5th Cir. 1952).

2. After watching the courts struggle with the *Culbertson* criteria for several years, the Bureau of Internal Revenue in 1952 issued Mim. 6767, 52-1 C.B. 111, "to clarify" its position "with respect to some aspects of the family partnership problem . . . concerning which there appears [!] to be uncertainty." But it was not possible in this area to single out relatively precise criteria for taxability, as was done in the Clifford Regulation, and the Bureau's position is consequently less clearly delineated.

3. The foregoing Mimeograph is applicable only to 1950 and earlier years. For the Revenue Act of 1951 introduced § 191 (now § 704(e)) into the Code, applicable to taxable years beginning after December 31, 1950.

4. See Bruton, "Family Partnerships and the Income Tax—The *Culbertson* Chapter," 98 *U. of Pa. L. Rev.* 143 (1949); Diamond, "Recent Developments of Parent-Child Business Relationships," *11th Ann. N.Y.U. Inst. on Fed. Taxation* 1071 (1953).

5. *A* and *B* are members of an admittedly valid partnership for the conduct of a real estate and accounting business. The partnership agreement provides that all "outside" income received by either of them shall be contributed to the partnership and distributed between them in the same proportion as the income from the business activities of the firm. Is the arrangement as to "outside" income effective for federal income tax purposes? *Mayes* v. *United States*, 207 F.2d 326 (10th Cir. 1953); *Mayes* v. *Commissioner*, 21 T.C. 286 (1953). Can two lawyers, each having a retainer from a separate client, become partners by pooling their income and expenses, if neither performs any services except for his "own" client?

S. REPT. NO. 781

Senate Finance Committee, 82d Cong., 1st sess., 1951
51–2 C.B. 458, 485–486

Sec. 339 of your committee's bill [§ 191, '39 Code; § 704(e), '54 Code] is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income

from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

Although there is no basis under existing statutes for any different treatment of partnership interests, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property. Many court decisions since the decision of the Supreme Court in *Commissioner* v. *Culbertson* (337 U.S. 733) have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnership. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated by a desire to benefit the partnership business. Others seem to assume that a gift of a partnership interest is not complete because the donor contemplates the continued participation in the business of the donated capital. However, the frequency with which the Tax Court, since the *Culbertson* decision, has held invalid family partnerships based upon donations of capital, would seem to indicate that, although the opinions often refer to "intention," "business purpose," "reality," and "control," they have in practical effect reached results which suggest that an intrafamily gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in *Commissioner* v. *Tower* (327 U.S. 280) and the opinion of the Supreme Court in *Commissioner* v. *Culbertson* (337 U.S. 733), which attempted to explain the *Tower* decision, afford any justification for the confusion is not material—the confusion exists.

The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership, which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of *Helvering* v. *Clifford* (309 U.S. 351). The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale.

Not every restriction upon the complete and unfettered control by the donee

of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.

Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner.

Therefore, the bill provides that in the case of any partnership interest created by gift the allocation of income, according to the terms of the partnership agreement, shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested. However, the distributive share of a partner in the earnings of the partnership will not be diminished because of absence due to military service.

When more than one member of a family is a member of a partnership, all interests purchased by one member of the family from another will be treated as though the transfer were made by gift. For this purpose the family of an individual includes his spouse, ancestors, lineal descendants, and any trust for the primary benefit of such persons.

Note

1. What criteria will determine whether "reasonable compensation" has been allowed to the donor for his services? See *Patton* v. *Commissioner*, *supra*, p. 239. Will the requirement of such an allowance destroy the usefulness of the family partnership as a tax reduction device? Prior to § 191's enactment, it was held in several cases that a family partnership was either valid *in toto* or invalid *in toto*. Thus, in *Canfield* v. *Commissioner*, 168 F.2d 907 (6th Cir. 1948), the Tax Court was reversed for holding, in disregard of the partnership agreement, that 75 per cent of the firm's income should be attributed to the husband's services (and taxed to him) and that the remaining 25 per cent should be attributed and taxed to husband and wife in proportion to their capital interests. See also *Hartz* v. *Commissioner*, 170 F.2d 313, 318 (8th Cir. 1948), stating, however, that an "artificial" allocation of income among the partners "might constitute sufficient ground for a finding that the alleged partnership was a sham or a device to avoid the payment of taxes." Mim. 6767, *supra*, p. 348, however, adheres to the view for years before 1951 that there are intermediate cases where the partnership should not be totally disregarded but where income should be allocated according to the values of services and capital rather than according to the agreement itself. Reallo-

cation in appropriate cases was endorsed in *Weiss* v. *Johnson*, 206 F.2d 350 (2d Cir. 1953):

> No reason is perceived in either law or logic why, if a partnership may be found wholly invalid for a misuse of this business device as an instrument of tax evasion, it may not also be found partially invalid for a like ground.

See also *Wofford* v. *Commissioner*, 207 F.2d 749 (5th Cir. 1953), where, although an alleged partner was not recognized as such, its ownership of a portion of the capital used by the firm was acknowledged, and part of the firm's income was held to be compensation for the use of the "partner's" capital.

2. The student should carefully examine the regulations issued pursuant to § 191 with respect to minors, trustees as partners, and limited partnerships. Regs. 118, Sec. 39.191-1(b)(7)-(9). The tax treatment of these situations will greatly influence the use of § 191 because by and large the donor of an interest in a family partnership will wish to retain control over its management, especially in view of the fact that any general partner may always bring a partnership to an end and force dissolution. Uniform Partnership Act, §§ 31(1)(b) and 31(2). Can the head of the family maintain control over the enterprise by taking in the children as limited partners only? By transferring their shares in the firm into trusts of which he is the trustee? By relying simply on his powers as the natural guardian of the children? For a discussion of the use of limited partnerships and trusts as partners under the pre-Section 191 law, see *Toor* v. *Westover*, 200 F.2d 713 (9th Cir. 1952).

3. See Comment, Family Partnerships and the Revenue Act of 1951, 61 *Yale L.J.* 541 (1952).

4. *Family Corporations*

OVERTON v. COMMISSIONER
OLIPHANT v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1947
162 F.2d 155

Before SWAN, AUGUSTUS N. HAND and FRANK, Circuit Judges.

SWAN, Circuit Judge.

These appeals involve gift tax liability of petitioner Overton for the years 1936 and 1937 and income tax liability of petitioner Oliphant for the year 1941. Each petitioner was held liable on the theory that dividends received by his wife in the year in question on stock registered in her name on the books of Castle & Overton, Inc., a New York corporation, were income of the husband for tax purposes. No gift tax return with respect to such dividends was filed by Mr. Overton in 1936 or 1937, and the dividends received by Mrs. Oliphant in 1941 were not included in her husband's return for that year.

There is no dispute as to the evidentiary facts. They are stated in detail in the opinion of the Tax Court, 6 T.C. 304, and will be here repeated only so far as may be necessary to render intelligible the discussion which follows. On May 26, 1936 the corporation had outstanding 1,000 shares of common stock without par value but having a liquidating value of at least $120 per share. On that date, pursuant to a plan devised to lessen taxes, the certificate of incorporation was amended to provide for changing the outstanding common stock into 2,000 shares without par value, of which 1,000 were denominated Class A and 1,000 Class B. The old stock was exchanged for the new, the shareholders then gave the B stock to their

respective wives, and new certificates therefor were issued to the wives. The B stock had a liquidating value of one dollar per share, everything else on liquidation was to belong to the holders of the A stock, who had also the sole voting rights for directors and on all ordinary matters.[1] By virtue of an agreement made in April 1937 restricting alienation of their stock, the wives were precluded from realizing more than one dollar a share by selling their shares. The A stock was to receive noncumulative dividends at the rate of $10 a share per year before payment of any dividend on the B stock; if dividends in excess of $10 per share were paid on the A stock in any year, such excess dividends were to be shared by both classes of stock in the ratio of one-fifth thereof for the A stock and four-fifths for the B stock. During the six year period ending in December 1941, the dividends paid on B stock totaled $150.40 a share as against $77.60 a share paid on A stock. In 1941 the A stock had a book value of $155 per share.

The Tax Court was of opinion that the 1936 arrangement, though made in the form of a gift of stock, was in reality an assignment of part of the taxpayers' future dividends. Unless form is to be exalted above substance this conclusion is inescapable. Since the total issue of B stock represented only $1,000 of the corporate assets, it is plain that the property which earned the large dividends received by the B shareholders was the property represented by the A stock held by the husbands. In transferring the B shares to their wives they parted with no substantial part of their interest in the corporate property. Had they been content to transfer some of the original common stock, they could have accomplished their purpose of lessening taxes on the family group,[2] but they would then have made substantial gifts of capital. The arrangement they put into effect gave the wives nothing, or substantially nothing, but the right to future earnings flowing from property retained by the husbands. That anticipatory assignments of income, whatever their formal cloak, are ineffective taxwise is a principle too firmly established to be subject to question. . . . We think the Tax Court correctly applied this principle to the facts of the case at bar.

Orders affirmed.

COMMISSIONER v. LAUGHTON

U. S. Court of Appeals, Ninth Circuit, 1940
113 F.2d 103

Before DENMAN, MATHEWS, and STEPHENS, Circuit Judges.

DENMAN, Circuit Judge.

This is a review of a decision of the Board of Tax Appeals holding Laughton not liable for income taxation for moneys paid in the tax years 1934 and 1935 by various American motion picture producers to Motion Pictures & Theatrical Industries, Ltd., a British corporation, hereafter called Industries, Ltd., all of whose shares, except those qualifying the directors, were owned by Laughton, for services in the United States rendered by that company to the American producers by

[1] Whether the amendment of the certificate of incorporation excluded B shareholders from voting on extraordinary matters specified in section 51 of the Stock Corporation Law of New York, McK. Consol Laws, c. 59, in effect on May 26, 1937, the Tax Court did not find it necessary to determine; nor do we.

[2] See Blair v. Commissioner, 300 U.S. 5, 57 S. Ct. 330, 81 L. Ed. 465.

supplying Laughton, an employee of Industries, Ltd., as an actor in their motion pictures.

Laughton was employed as an actor by the company under an exclusive contract for five years at a salary very much less than that the company received for "loaning" him to the producers. Such hiring and loaning is established practice in the moving picture industry. The Commissioner contends that the corporate entity should be ignored for income tax purposes and the compensation deemed paid directly from the producers to Laughton. The Board held the corporation had a business purpose and hence its entity intervened.

The Board decision was made before the Supreme Court decided *Higgins* v. *Smith*, 308 U.S. 473, 60 S. Ct. 355, 84 L. Ed. 406, which we consider controlling this proceeding. In that case Smith, the taxpayer, dominated a corporation of which he owned all the shares through

> officers and directors [who] were [his] subordinates. . . . While its accounts were kept completely separate from those of the taxpayer, there is no doubt that Innisfail [the corporation] was his corporate self. (60 S. Ct. 356.)

That is to say, the corporation was "wholly owned" both as to management by the taxpayer's subordinates and as to stock interest.

Smith, having in mind reducing his taxes, sold to this "corporate self" certain of his shares of stock at a loss, which he claimed as a deduction from his taxable income. It was held that, assuming title had passed to his corporate self, he had such a command of the securities thereafter that "There is not enough of substance in such a sale finally to determine a loss." 60 S. Ct. 357.

In a long discussion the court, *inter alia*, states that

> Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity. (60 S. Ct. 357.)

That the phrase "wholly owned" in this dictum regarding an instruction to the jury means something more than mere stock ownership is to be inferred from a ruling at the end of the opinion. There certain evidence of past transactions between taxpayer and corporation was admissible because the court thought "it apparent that this evidence was entirely relevant to the present issue; the history of the taxpayer's relations with the corporation shed considerable light on the actual effect of the sale in question." 60 S. Ct. 359.

Later, considering *Burnet* v. *Commonwealth Improvement Company*, 287 U.S. 415, 53 S. Ct. 198, 77 L. Ed. 399, in which the sole stockholder so utilized the corporation that it made a book profit and the corporation was held liable as a separate taxable entity, the court says:

> . . . A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged *tax event* is *unreal or a sham* may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income

and its benefits which marks the real owner of property." (Emphasis supplied.) *Higgins* v. *Smith*, *supra*, 60 S. Ct. 358.

It is arguable that the *Higgins* decision means that no matter what the particular "tax event" may be, if it be more profitable to the tax collector to disregard the intervening corporate entity this must be done. However, it seems to us that if this were the intent of the court it would have said so and not spread its consideration of the cases over many pages of the opinion with such qualifying language as is quoted above.

We take the opinion to mean that the "tax event" is not an unreal attempt to use a corporation for a sham transaction, procuring an advantageous tax consequence to the taxpayer, if it may be considered as one primarily for an independent business purpose and not a transfer of assets (here Laughton's services), with a retention of their control, solely to reduce tax liability.

Applying this criterion to the instant case the question here is not whether Industries, Ltd., was formed for a business purpose. The corporation in *Higgins* v. *Smith*, *supra*, was formed and used for profitable business purposes causing it to pay federal and state income taxes. The question is whether Laughton's hiring of himself to Industries, Ltd., for a salary substantially less than the compensation for which the corporation supplied his services as its employee to various motion picture producers, constituted, in effect, a single transaction by Laughton in which he received indirectly the larger sum paid by the producers.

The Board made no finding on this issue. It seemed to think it sufficient to find no more than that the corporation itself had a business purpose. This places before us the determination whether the evidence warrants us to return the case to the Board with the freedom to make such a finding, or whether it permits only the finding that Laughton's transaction with regard to his services to the corporation is an "unreal and/or a sham" attempt at tax avoidance.

There is evidence here from which it might be inferred that tax avoidance by a sham transfer by Laughton of his services was the primary purpose of the use of the corporation. There is also evidence from which it may be inferred that it was not. The testimony is uncontradicted that Laughton had no intention to avoid taxes; that the purpose of engaging himself for five years as an employee of Industries, Ltd., was to join his efforts with other employees of the company to create motion pictures; that he contributed six thousand pounds to the capital of the company for his stock interest, other than the qualifying shares of his directors, and also royalties in certain enterprises in which he was interested; that he contemplated that the corporation would gather further accretions of capital by its use of his services as its agent for a time to other motion picture producers.

It is also uncontradicted that during the two tax years in question, 1934 and 1935, sufficient capital was accumulated from all these sources for the corporation's active engagement in motion picture production at a later date; that the directors of his company were not dominated and controlled by him as in the case of *Higgins* v. *Smith*, *supra*, that, on the contrary, they were business men who ran the business with a free hand and never asked Laughton's permission in its conduct. It is a matter of law that the stockholders have no right to direct the conduct of the board of directors.

It is also uncontradicted that Laughton's motive was based on the theory that as an actor he would die poor. He had a Gerald DuMaurier in mind who died poor

> and he said that he was determined while he was on the crest of the wave to safeguard his resources, that he would engage the services of the finest writers in New York and technicians and cameramen and form a renaissance of the British film industry.

Laughton is an English actor and was then an artist of international renown. The Board properly could infer that one with the artistic temperament is likely to dissipate his income and that Laughton was farseeing enough to desire that compensation for his genius should be handled by independent business men.

On the other hand, it appears that Laughton borrowed heavily on secured loans from Industries, Ltd., during the tax years in question. He had a previous engagement for his services which was surrendered to the company, followed by a similar engagement directly with the company to furnish them as its employee. The minutes of the company show that he was present at many of the directors' meetings. Also there was a very wide disparity between the salary he received from the company and what he had previously been receiving as a motion picture actor, and a still wider disparity between his company salary and what was received by the company for his subsequent services.

We cannot say as a matter of law that findings of ultimate fact must be made one way or the other with reference to the issue as stated above. The administrative body must be left free to make its own inferences relevant to that issue. Our sole function with regard to administrative findings is to determine whether there is any substantial evidence to support them.

We hold that the case must be returned to the Board to make the findings this opinion indicates are required.

*Remanded.**

Note

1. As will be seen in Ch. 7, Sec. A, a corporation like the one organized by Laughton may be subjected to the virtually confiscatory personal holding company surtax if the bulk of its income comes from "hiring out" the services of a stockholder unless the income is distributed annually as earned. Many family corporations can avoid these special provisions, however, even though the corporate income may be created largely by the personal skill or services of the head of the family. By giving some of the stock to members of the family, he may reduce income taxes unless the corporate entity is disregarded and the income of the corporation is taxed to him.

Note the Court's remark in the *Overton* case, *supra*, pp. 351, 352.

> Had they been content to transfer some of the original common stock, they could have accomplished their purpose of lessening taxes on the family group, but they would then have made substantial gifts of capital.

Suppose the husband's services are a principal source of the corporation's earnings, and his compensation is inadequate. Could the Commissioner include in the husband's income a "constructive" salary to give him adequate compensation for his services? Or could the Commissioner treat dividends subsequently paid to the wife and children as assignments of the husband's past earnings? If a family partnership, after being held invalid for tax purposes, is incorporated, and the stock is divided among the former "partners" in proportion to their capital interests, will the Commissioner have any ground for attacking the arrangement? See Alexandre, "The Corporate Counterpart of the Family Partnership," 2 *Tax L. Rev.* 493 (1947); Johnson, "Taxing Dividends of Family Corporations—A Dissent," *id.* 566.

2. Assuming that the husband could take an inadequate salary without jeopardizing

* The proceedings on remand are not reported. [Ed.]

the normal tax treatment of a corporation (separate tax on corporate earnings; dividends taxed to stockholders only when paid), what are the tax pressures that would discourage use of this device for income-splitting?

3 As will be seen in Ch. 6, certain partnerships may elect to be treated as corporations, as a result of a new provision, § 1361 of the 1954 Code. The relationship of this new provision to § 704(e), the family partnership provision, remains to be worked out. If a family partnership distributes its income without making a reasonable allowance for compensation to the donor for his services, can the firm elect to be treated as a corporation under § 1361? Even if the reasonable compensation requirement of § 704(e) can be thus avoided, of course, the firm will have to pay a corporate income tax.

5. Other Intra-Family Arrangements and Transactions

HENSON v. COMMISSIONER

U. S. Court of Appeals, Fifth Circuit, 1949

174 F.2d 846

Before SIBLEY, HOLMES, and MCCORD, Circuit Judges.

MCCORD, Circuit Judge.

This is an appeal from a decision of the Tax Court sustaining a deficiency assessment against petitioner on income taxes alleged to be due for the year 1943.

The question presented is whether the Tax Court properly held $22,348.78 profit of the J. M. Henson Company for the period from August 1, 1943, to December 31, 1943, was taxable to petitioner as his income, even though on the former date he had executed a valid and complete gift of this Company to his wife.

The material facts are without dispute, and reveal that petitioner and his wife were married in the year 1925, and reside in Atlanta, Georgia. Sometime prior to August 1, 1943, petitioner became the owner of two business concerns known as the J. M. Henson Company, a baker's supply business, and the Dairy and Ice Cream Supply Company. The two businesses were located in the same building, used the same offices, equipment, bookkeeper and stenographic help, but did not have the same salesmen or customers. Separate sets of books were kept and different letterheads were used, and the inventories and bank accounts were maintained separately. There were three other people besides petitioner who shared in the profits of the Dairy and Ice Cream Supply Company, while petitioner alone received the profits of the J. M. Henson Company.

On August 1, 1943, petitioner conveyed to his wife, a woman of little business experience, his entire ownership and interest in the J. M. Henson Company. On the same day, Mrs. Henson wrote their bank in Atlanta a letter giving petitioner, her husband, authority to sign checks, drafts and notes for the company.[1] Later, petitioner filed an affidavit with the clerk of the county court, stating that his wife was the sole owner of the business. A similar notice was published in a paper of general circulation throughout the county. In 1944, petitioner filed a gift tax return, disclosing the gift of this Company to his wife, and paid the gift tax thereon. His wife also filed a donee's information return, and paid the tax on income earned by the Company from the date of the gift until the end of the year 1943.

[1] It is without dispute that after receiving such notice the bank would not lend money to the Henson Company unless the notes were signed by Mrs. Henson.

After August 1, 1943, the J. M. Henson Company continued to operate under substantially the same conditions and under the same name, except that petitioner was retained by his wife as manager of the company at a salary of $300.00 per month, which was substantially the same amount he had withdrawn for his services prior to the transfer. He maintained a personal account for himself and charged his expenses to it. His wife had no office in the place of business and was not normally consulted as to its operation and direction. Petitioner alone drew checks on the Company's bank account, in accordance with the grant of such authority from his wife. However, it is undisputed that after the date of the transfer, which was admittedly a bona fide gift and effective to pass title to the property under Georgia law, that petitioner's wife was the sole and absolute owner of the Company, with no strings attached. She had the right and absolute power to dispose of it by gift, sale, or will. She further had the power to borrow money on account of the business, and to employ and discharge managers or other company employees at will, although she never saw fit to exercise her prerogative in the latter respect during the tax year involved. Under and by virtue of the gift to his wife, petitioner had irrevocably divested himself of all legal title, right, interest, and control over the business, and remained as manager of the Company solely at his wife's pleasure. In fact, it appears that since March 1, 1944, or shortly thereafter, petitioner has no longer managed the Company, nor has he drawn any salary whatever from the Company account for his services, at least insofar as this record reveals.

We are of opinion the Tax Court erred in holding petitioner taxable on the income from the Company after he had executed an absolute gift of such business to his wife. *Blair* v. *Commissioner*, 300 U.S. 5, 11, 12, 57 S. Ct. 330, 81 L. Ed. 465, *Hardymon* v. *Glenn*, D.C., 56 F. Supp. 269, 273; *Simmons* v. *Commissioner*, 5 Cir., 164 F.2d 220, 223; *Kent* v. *Commissioner*, 6 Cir., 170 F.2d 131, 133. This case involves a valid and unconditional gift, complete and effectual for all purposes, and is clearly distinguishable from those family partnership tax cases relied upon by the Commissioner. *Cf. Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731; *Helvering* v. *Clifford*, 309 U.S. 331, 60 S Ct. 554, 84 L. Ed. 788; *Lusthaus* v. *Commissioner*, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679; *Commissioner* v. *Tower*, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135.

The Tax Court has evidently, in its decision, failed to recognize the distinction between actual control over income-producing property with consent of the true owner, and the absolute right of control over both the property and the income derived therefrom which adheres in a valid and legal title. The controlling question in such cases is, therefore, not whether actual control over the property is exercised, but whether the right of control in fact exists, not who earns the income from such property, but who has the right to receive it. *Cf. Werner* v. *Commissioner*, 7 T.C. 39.

Every owner of a business, particularly those of limited business experience, has the undoubted right to have it managed by another, even though that person be married to the owner. Moreover, every husband has a legal right to create a valid gift of his property in favor of his wife without being held liable for the income tax thereon, provided, of course, there are no conditions attached which would enable him to retain a legal dominion and control over the property, or to revoke

the transfer. No such conditions are found to exist here. In this case, the wife was no partner, but became the undisputed and absolute owner of the business, under and by virtue of the gift from her husband. Under such circumstances, the income therefrom was taxable to her alone, and not to the petitioner. *Simmons* v. *Commissioner*, 5 Cir., 164 F.2d 220, 223; *Hardymon* v. *Glenn*, D.C., 56 F. Supp. 269, 273; *Edson* v. *Lucas*, 8 Cir., 40 F.2d 398; *Pearce* v. *Commissioner*, 315 U.S. 543, 554, 62 S. Ct. 754, 86 L. Ed. 1016.

It follows that the decision of the Tax Court should be, and the same is hereby *Reversed.*

Note

1. Was it crucial that the husband's salary was equal to his previous withdrawals? Was $300 per month the value of the husband's services, the rest of the profits being attributable to capital?

2. In *Visintainer* v. *Commissioner*, 187 F.2d 519 (10th Cir 1951), part of the income of a sheep ranch business was held taxable to minor children. Their father, who managed the business, gave some of the sheep to the children. The transferred sheep were branded, but were not separated from the herd. The income and expenses of the entire business were divided among the father and children in proportion to the sheep owned. The Tax Court held that, although the father "stopped one step short of the usual family partnership—the execution of the partnership agreement," the entire income of the business should be taxed to him under the *Tower* case. The Court of Appeals reversed, holding that there were bona fide gifts of the sheep to the children and that the income followed the sheep See also *Alexander* v. *Commissioner*, 190 F.2d 753 (5th Cir. 1951); *Sandberg* v. *Commissioner*, 8 T.C 423 (1947). For another approach in a comparable context, see *Hogle* v. *Commissioner*, 132 F.2d 66 (10th Cir. 1942). And see again *Strauss* v. *Commissioner*, *supra*, p. 307.

3. See *FitzGibbon* v. *Commissioner*, 19 T.C. 78 (1952), involving a "sale" of stock by a mother to her children, the purchase price to be paid in instalments out of the dividends received (less income tax thereon) by the children. The court found that the transaction was not a bona fide sale, and held that the dividends were taxable to the donor.

WHITE v. FITZPATRICK

U. S. Court of Appeals, Second Circuit, 1951
193 F.2d 398, cert. den. 343 U.S. 928 (1952)

Before AUGUSTUS N. HAND, CHASE, and CLARK, Circuit Judges.

CLARK, Circuit Judge.

Involved in this appeal is the recurring problem of tax savings claimed as a consequence of a transfer of property from husband to wife with resulting lease or license back. Here neither the Commissioner of Internal Revenue nor the district court has accepted the taxpayer's view of the transactions; and he now appeals from the judgment against him in his action for a refund of the deficiency assessed against him by the Commissioner upon his income and victory taxes for the years 1941, 1943, and 1944.

The following are the facts of the case as stipulated by the parties and found by the trial court. During the years in question and for some time prior thereto, plaintiff engaged in the manufacture of chokes for use on the barrels of shotguns, as

sole proprietor of the Poly Choke Company, an unincorporated business. Beginning in 1939 the company occupied certain properties—land, three factories, a garage, and an office—under a lease coupled with a nontransferable option to purchase for $15,370. Plaintiff had developed the basic invention for this device himself and obtained a United States patent for it on December 27, 1932.

On January 21, 1941, he entered into a written agreement with his wife, transferring "the entire right, title and interest in and to" the patent, "to the full end of the term of said patent," for a stated consideration of $10. The following day his wife licensed the exclusive manufacturing right back to him "to the full end of the entire term of said patent." The assignment back was subject to cancellation only if (a) payments fell into sixty days' arrears, or (b) receivership, bankruptcy, forced assignment, or other financial difficulty made it impossible for her husband to carry on his manufacturing concern. It provided for royalties of $1 on each product marketed. Plaintiff filed a gift tax return for the year declaring the fair market value of the patent to be $10,000 and for the next four years, 1941–1944 inclusive, paid his wife some $60,000 as royalties.

At about the same time, December 27, 1940, plaintiff's wife also purchased the property on which the company was located for $16,800 and immediately leased it to her husband orally. On the next day plaintiff made a gift to his wife of $16,175 to cover the purchase price and filed a gift tax return for that amount. Rental payments for the years 1941–1944 inclusive were $1,500 a year, which was the amount that plaintiff had been paying to the original lessor; in 1944, plaintiff in addition paid his wife some $5,000 as "an adjustment in rent."

During the years in question plaintiff deducted both rental payments and royalties as business expenses. After investigation and audit, the Commissioner of Internal Revenue issued a deficiency notice disallowing the deductions in 1948. Plaintiff paid the total deficiency of about $47,000 thus assessed and brought this action for refund. The district court found (1) that the plaintiff's motivation was to make good certain losses in the value of securities held by his wife and to minimize income taxes for the family group, but (2) that

> it was the taxpayer's expectation that no action would be taken by the wife in exercise of her rights of ownership of the patent or real property which would be detrimental to the plaintiff's interests.

The court then concluded that by the gifts and license and lease back

> by reason of the family relationship the husband retains effective control of the patent and real property, while valid transfers for other purposes, will not form a valid basis for deduction of royalties and rent paid by the husband to the wife as business expenses in arriving at the taxpayer's net income for income tax purposes.

The bare assignment of the patent was legally adequate to transfer all rights adhering thereto to the wife. Likewise the land was purchased in the name of the wife alone. From this plaintiff contends on appeal that the wife's legal title and power were absolute and subject to no conditions or future claims whatsoever. Moreover, there is no evidence, nor does defendant contend, that the plaintiff derived any direct benefit in the form of income from these transactions. Therefore, plaintiff argues that, since the royalties and rents were both ordinary in nature for his type of business and reasonable in amount, they constitute valid business expenses under I.R.C. § 23(a)(1)(A) [§ 163(a)(3), 1954 Code], which author-

izes the deduction from gross income of "ordinary and necessary expenses" paid "in carrying on any trade or business." See *Welch* v. *Helvering*, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212; *Deputy* v. *DuPont*, 308 U.S. 488, 60 S. Ct. 363, 84 L. Ed. 416.

Underlying reality, however, contradicts this appearance of a complete assignment. "Title" to the patent and land may legally reside in the plaintiff's wife, practically and actually, as the district court concluded, control rests with the husband as effectively as if he had never made the gift of the patent to his wife or given her the money with which to buy the property. Assignment and gift cannot be divorced for tax purposes from their accompanying agreements whereby the husband retained dominion. And in fact plaintiff never intended that it should be; he admitted the impossibility of conducting the business without this basic patent or of finding a comparable factory site in Connecticut. His wife was neither equipped nor evinced any desire to exercise or transfer any rights to the use of either of the properties; in the case of the patent at least, it is clear that she had no legal right to do so, save in the unlikely event of the husband's default. The sole practical effect of these transactions, therefore, was to create a right to income in the wife, while leaving untouched in all practical reality the husband-donor's effective dominion and control over the properties in question. It is not without significance on this point that the arrangement made was actually disadvantageous to the business. For it passed over the reduction of land charges which the taxpayer might have made by taking up his option to purchase in order to create the income right in the donor's wife, and that, too, at a greater capital cost. For the statutory purposes, the mere creation of a legal obligation to pay is not controlling. *Interstate Transit Lines* v. *C. I. R.*, 8 Cir., 130 F.2d 136, affirmed 319 U.S. 590, 63 S. Ct. 1279, 87 L. Ed. 1607.

In this respect, then, the case before us does not involve the definite problem presented by the completed assignment of a created product which divided our court and the Fourth Circuit, both inter- and extra-murally, in the two cases of *Wodehouse* v. *C. I. R.*, 2 Cir., 177 F.2d 881, Id., 4 Cir., 178 F.2d 987. Gift and retained control must be regarded as inseparable parts of a single transaction, especially since it was only in their sum total that they had any reality in regard to the conduct of plaintiff's business. To isolate them, as would be necessary to bring them within the rationale of our own majority ruling in *Wodehouse* v. *C. I. R.*, *supra*, is to hide business reality behind paper pretense.

For the question here is as to the tax consequences of a formal gift of certain income-producing properties by the husband to his wife coupled with the informal retention of administrative control—the transfer, in effect, of the right to receive income and the retention of those complex of "use rights" which are usually compressed in the term "ownership." In the context of I.R.C. § 23(a)(1)(A), the question is a rather new one; under I.R.C. § 22(a) [§ 61(a), 1954 Code], where it arises in the definition of gross income problems, it is not. And we think the line drawn in the precedents under the latter section is the same as that in the field of deductibility of business expenses. Plaintiff here, for example, accepts as his own the income he has received on the patent equivalent to the royalties he is paying his wife, but then seeks to deduct it as a business expense; in effect this is not different from claiming that the gift itself made the original income hers in the first place.

We think, therefore, that the principles governing the intermarital transfer of income enunciated in *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, and re-enforced by later cases, are also decisive here. In the case at bar, plaintiff assigned the "legal title" to the patent and provided for his wife's assumption of the "legal title" to the land; but he retained, by formal agreement in the first case, by informal arrangement in the second, the administrative control of these properties. His wife had the right to income, but he had a right to the use of the patent and land. *Henson* v. *C.I.R.*, 5 Cir., 174 F.2d 846, is thus distinguishable. The *Clifford* rule is clear, that this direct control, when fused with the indirect control which we must imply from a formal but unsubstantial assignment within the closed family group displaying no obvious business purpose, renders the assignment ineffective for federal tax purposes. The same result should obtain whether the question arises under § 22(a) or § 23(a)(1)(A) of the Internal Revenue Code.

Plaintiff relies heavily on *Skemp* v. *C. I. R.*, 7 Cir., 168 F.2d 598, and *Brown* v. *C. I. R.*, 3 Cir., 180 F.2d 926, certiorari denied *C. I. R.* v. *Brown*, 340 U.S. 814, 71 S. Ct. 42, 95 L. Ed. 598. These cases, which are criticized in reasoned discussions in 51 *Col. L. Rev.* 247 and 59 *Yale L.J.* 1529, may be thought to go to the verge of the law in support of what are essentially intrafamily transfers. But both, being to trustees, were sufficiently outright, to be distinguishable from our present case Both involved claimed deductions under I.R.C. § 23(a)(1)(A). In the first, a plaintiff-physician had deeded the building in which he had his office in irrevocable trust for twenty years or until the prior deaths of both himself and his wife, with their children as beneficiaries. He then leased the building back for ten years. In the second, there were two trusts, also irrevocable, terminating on the majority of the beneficiaries who were children of the settlor, coupled with an immediate leaseback of the corpus properties. In upholding the deductions, both courts expressly emphasized the independence of the trustees. It is probable that a like result would probably have obtained had the question been one of gross income under I.R.C. § 22(a). For three factors determine attributability of income to the settlor of a family trust. Whether these are conjunctive tests, see *Helvering* v. *Clifford*, *supra*, 309 U.S. at page 335, 60 S. Ct. 554, or alternative, under the new *Clifford* regulations, U.S. Treas. Reg. No. 118, § 39.22(a)-21; *Kay* v. *C. I. R.*, 3 Cir., 178 F.2d 772, it seems likely that in both the cases relied on, income would have been attributable to the trusts and thus to the beneficiaries, rather than the settlors. For (1) the settlors retained no reversionary interests; (2) they retained no dispositive power over either corpus or income;[1] and (3) administrative control was not exercisable primarily for the benefit of the settlors.[2] See Alexandre, "Case Method Restatement of the New Clifford Regulations," 3 *Tax L. Rev.* 189.

The Supreme Court has long emphasized the test of retention of practical ownership in passing on the tax consequences of intra-family assignment. Soll, "Intra-Family Assignments: Attribution and Realization of Income, 6 *Tax L. Rev.* 435. In the recent case of *C. I. R.* v. *Sunnen*, 333 U.S. 591, 68 S. Ct. 715, 92 L. Ed. 898, involving the assignment by the inventor-husband of patent licensing contracts to

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[1] In the *Skemp* case, 7 Cir, 168 F.2d 598, 599, "the taxpayer . . . did reserve the right to rent all or a part of the building 'at a rental to be determined by the trustee' "; but this does not constitute "beneficial enjoyment" of the property in the *Clifford* sense. Moreover, both leases back were for a term and were not coextensive with the life of the trust.

[2] Here the factor of independent trusteeship is crucial. And it is in this respect that the instant case differs on its facts from the *Skemp* and *Brown* results

his wife, the court said, "The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes," 333 U.S. at page 604, 68 S. Ct. at page 725, and went on to note that "The taxpayer's controlling position in the corporation also permitted him to regulate the amount of royalties payable to his wife." 333 U.S. at page 609, 68 S. Ct. at page 725. In essence the assignment in the present case was effective only to the extent of transferring the single right to receive income. It is now too late to question the well-established proposition that mere assignment of such a right will not suffice to insulate the grantor from tax liability under § 22(a), and we think like tax results must obtain under § 23(a)(1)(A). See *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731; *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75; *Helvering* v. *Eubank*, 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81. The recent case of *C. I. R.* v. *Culbertson*, 337 U.S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659, has established the test in the family-partnership field, whether or not there existed as part of the arrangement a "bona fide intent" to have the donee exercise a real part in management, thus giving a final blessing to the doctrine that "true ownership" is decisive in matters of federal taxation. See also *C. I. R.* v. *Tower*, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L.R. 1135; *Harrison* v. *Schaffner*, 312 U.S. 579, 61 S. Ct. 759, 85 L. Ed. 1055; *Ingle Coal Corp.* v. *C. I. R.*, 7 Cir., 174 F.2d 569.

Since here we find no evidence of a potential exercise of "control and management" on the part of the donee, only of "passive acquiescence to the will of the donor," *C. I. R.* v. *Culbertson*, *supra*, 337 U.S. at pages 747, 748, 69 S. Ct. at page 1217, since the transaction is in all practical respects a "mere paper reallocation of income among the family members," *C. I. R.* v. *Tower*, *supra*, 327 U.S. at page 292, 66 S. Ct. at page 538, and since the husband has remained the actual enjoyer and owner of the property, payments to the wife do not constitute valid business deductions within the statute. See *Johnson* v. *C. I. R.*, 2 Cir., 86 F.2d 710; *W. H. Armston Co.* v. *C. I. R.*, 5 Cir., 188 F.2d 531.

Affirmed.

CHASE, Circuit Judge (*dissenting*).

Perhaps it would be desirable to protect the revenue by amending Sec. 23(a)(1)(A) to exclude from the business expense deductions now allowed those which become necessary only because of intrafamily gifts of property used, or to be used, in the business. But that is a matter to be determined by Congress and, until it acts, I think courts are bound to give effect taxwise to gifts which are fully effective otherwise.

There is, I think, some distinction between the disallowance of the royalty and the disallowance of the rent deductions. It is that the transfer of the patent by gift to the wife was a transfer of needed business property already owned by the taxpayer which was intended to, and did, make it necessary to pay her the royalties. The gift of the money, however, which she used together with some of her own to buy the building never owned by the taxpayer was not shown to have been of money which had any connection with the business at all and the net result from the standpoint of the taxpayer and his business was merely a change in landlord. However, as I view this case, it is not necessary to rely upon this distinction.

In respect to the claimed deductions, the decisive factor as the statute is now, is whether the rent and royalty payments were

> required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he had no equity.

Sec. 23(a)(1)(A). The findings, based on evidence adequately supporting them, show that everything was done to transfer the legal and equitable titles both to the patent and to the building absolutely to the wife, and the ownership she thereby acquired gave her the right to whatever she could get by way of royalties and rents which were, of course, taxable to her as income. And, as Sec. 23(a)(1)(A) is now so broad that no exception is made because of the way in which business expenses become necessary, i. e., by gift or otherwise, the reasonable royalties and rents the husband paid her were, I think, well within the scope of the statute, being "required" by the license and lease arrangements, and therefore deductible. *Skemp v. Commissioner*, 7 Cir., 168 F.2d 598; *Brown* v. *Commissioner*, 3 Cir., 180 F.2d 926, certiorari denied, 340 U.S. 814, 71 S. Ct. 42, 95 L. Ed. 598. See also *Henson* v. *Commissioner*, 5 Cir., 174 F.2d 846. The fact that in the *Skemp* and *Brown* cases the transfers were to independent trustees for the benefit of family members is a distinction without a difference since that bore only on the completeness of the gifts and reasonableness of the royalties and rentals paid, both here shown and found. *W. H. Armston Co.* v. *Commissioner*, 5 Cir., 188 F.2d 531, is distinguishable as an instance of a disguised transfer of dividends to a large stockholder of the corporation.

The cases dealing with problems arising under Sec. 22(a), I.R.C. as to the identity of the taxpayer liable for taxes payable by some one, on which my brothers so much rely, help little, if any, in determining what deductions an identified taxpayer may take under Sec. 23(a)(1)(A) in computing his net income. Assuming, arguendo, that these cases are relevant,[1] factually they are inapplicable. The only basis pointed out by the majority for applying these cases to the facts before us is that the license of the patent and the lease of the buildings given to the taxpayer left "untouched in all practical reality the husband-donor's effective dominion and control over the properties in question." But whatever control the taxpayer received was the control of a licensee and lessee and was conditioned upon making the payments here claimed to be deductible. It would seem erroneous, therefore, to deny the claimed deduction on this basis.

One other point warrants brief mention. My brothers apparently think that the taxpayer is no longer entitled to any rent deduction because, presumably, he could have used the money he gave his wife to buy the building himself and then he would have had no rent to pay. If he had done so, no doubt he would have been allowed as deductions the maintenance costs, taxes, etc., which must have been included in the rent he paid his wife to make it reasonable over all but the effect of this decision may deprive him of even them. I cannot help but think that my

[1] The only issue to which these cases could be relevant is whether or not the taxpayer was "required" to pay the royalties and rents as a condition to using the property since that is the test set forth in the statute In order to be relevant to this issue, and to hold as the majority does, it would seem that one must accept the premise that a donor who retains sufficient control over property transferred by him so as to make any income from that property includible in the donor's gross income under Sec. 22(a), is not, as a matter of law, "required" to pay the donee for its use even though he has entered into a firm, and legally enforceable, obligation so to do.

brothers have mistakenly applied the business purpose rule of cases like *Gregory* v. *Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, to a situation where what the taxpayer did was merely to use permissible business judgment as to whether he would increase his business investment or continue to pay reasonable rent.

I would reverse and remand for a judgment for the appellant.

Note

With this case, the student should compare *Dorzback* v. *Collison*, 195 F.2d 69 (3d Cir. 1952). See also *Preston* v. *Commissioner*, 132 F.2d 763 (2d Cir. 1942), and *Commissioner* v. *Park*, 113 F.2d 352 (3d Cir. 1940), allowing taxpayers to deduct interest paid on their own bonds which had been transferred by gift, directly or in trust, to members of their families. For an extensive review of the cases, see *Woodward* v. *U. S.*, 106 F. Supp. 14 (N.D. Ia. 1952).

I.T. 3812

Bureau of Internal Revenue, 1946
46–2 C.B. 29

Advice is requested whether, for Federal income tax purposes, the value of meals and lodging furnished by a father to his unemancipated minor child is includible in the gross income of the child and deductible as wages by the father where the employer-employee relationship exists between them.

It is pointed out that in many instances wages paid to minor children amount to less than $500, but if the value of meals and lodging which is furnished by the father to his child constitutes additional wages, the gross income of the child would frequently exceed $500. In such cases, the child would be required to file an income tax return, and the father would lose the surtax exemption of $500 on account of the child.*

In I.T. 3767 (C.B. 1945, 101) it was held that reasonable wages paid by a father to his unemancipated minor child for personal services actually rendered as a bona fide employee in the conduct of a trade or business, or in the production of income, are deductible as ordinary and necessary expenses, for Federal income tax purposes, for taxable years beginning after December 31, 1943. However, in order to obtain such a deduction, the father must establish that a bona fide employer-employee relationship exists between him and the child. In determining whether there is in fact such a relationship, consideration must be given to whether the father is dealing with his minor child, for the purpose of employment, as he would deal with a stranger under the same circumstances. Thus, there should be a satisfactory showing by the father that the usual conditions of employment, such as duties, hours of work, amount of wages, and time of payment of wages, had been agreed upon to the same extent as they would have been had the father been engaging the services of a stranger. If wages are paid pursuant to an arrangement in the guise of an employer-employee relationship, entered into either before or

* A dependent may now receive up to $600 of gross income, and the dependency exemption, available against both normal tax and surtax, is also now $600. Section 151 (e) (1) (A). Moreover, the 1954 Code removes the gross income limitation for children of the taxpayer who are under the age of 19 or students, § 151 (e) (1) (B), but the taxpayer must still show that he furnished over half the dependent's support. [Ed.]

after the services are performed, a claimed deduction for wages paid will not be allowed.

Section 24(a)(1) [see § 262 of the 1954 Code] provides that in computing net income no deduction shall in any case be allowed in respect of personal, living, or family expenses, except extraordinary medical expenses which are deductible under § 23(x) [§ 213, '54 Code]. A father is legally liable for the support and maintenance of his minor children, and the cost of meals and lodging which he furnishes them constitutes a personal expense.

It is held that, for Federal income tax purposes, the value of meals and lodging furnished by a father to his unemancipated minor child is not includible in the gross income of the child and is not deductible as wages in computing the net income of the father, even though an employer-employee relationship exists between them. If the father takes the child's earnings and utilizes them for his own purposes, or if the father requires the child to purchase his own clothing or other necessities which the father is obligated to furnish, the deduction of the child's earnings as a business expense should be disallowed to that extent.

McWILLIAMS v. COMMISSIONER

Supreme Court of the U. S., 1947
331 U.S. 694

MR. CHIEF JUSTICE delivered the opinion of the Court.

The facts of these cases are not in dispute. John P. McWilliams, petitioner in No. 945, had for a number of years managed the large independent estate of his wife, petitioner in No. 947, as well as his own. On several occasions in 1940 and 1941 he ordered his broker to sell certain stock for the account of one of the two, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible. He told the broker that his purpose was to establish tax losses. On each occasion the sale and purchase were promptly negotiated through the Stock Exchange, and the identity of the persons buying from the selling spouse and of the persons selling to the buying spouse was never known. Invariably, however, the buying spouse received stock certificates different from those which the other had sold. Petitioners filed separate income tax returns for these years, and claimed the losses which he or she sustained on the sales as deductions from gross income.

The Commissioner disallowed these deductions on the authority of § 24(b)* of the Internal Revenue Code, . . . which prohibits deductions for losses from "sales or exchanges of property, directly or indirectly . . . between members of a family," and between certain other closely related individuals and corporations.

On the taxpayers' applications to the Tax Court, it held § 24(b) inapplicable, following its own decision in *Ickelheimer* v. *Commissioner*,[1] and expunged the Commissioner's deficiency assessments. The Circuit Court of Appeals reversed the Tax Court and we granted certiorari because of a conflict between circuits and the importance of the question involved.

Petitioners contend that Congress could not have intended to disallow losses

* §§ 267(a)(1) and 267 (b)(1) of the 1954 Code. [Ed.]

[1] 45 B.T.A. 478, affirmed, 2 Cir., 132 F.2d 660, 145 A.L.R. 556.

on transactions like those described above, which, having been made through a public market, were undoubtedly bona fide sales, both in the sense that title to property was actually transferred, and also in the sense that a fair consideration was paid in exchange. They contend that the disallowance of such losses would amount, pro tanto, to treating husband and wife as a single individual for tax purposes.

In support of this contention, they call our attention to the pre-1934 rule, which applied to all sales regardless of the relationship of seller and buyer, and made the deductibility of the resultant loss turn on the "good faith" of the sale, *i.e.*, whether the seller actually parted with title and control. They point out that in the case of the usual intra-family sale, the evidence material to this issue was peculiarly within the knowledge and even the control of the taxpayer and those amenable to his wishes, and inaccessible to the Government. They maintain that the only purpose of the provisions of the 1934 and 1937 Revenue Acts—the forerunners of § 24(b)—was to overcome these evidentiary difficulties by disallowing losses on such sales irrespective of good faith. It seems to be petitioners' belief that the evidentiary difficulties so contemplated were only those relating to proof of the parties' observance of the formalities of a sale and of the fairness of the price, and consequently that the legislative remedy applied only to sales made immediately from one member of a family to another, or mediately through a controlled intermediary.

We are not persuaded that Congress had so limited an appreciation of this type of tax avoidance problem. Even assuming that the problem was thought to arise solely out of the taxpayer's inherent advantage in a contest concerning the good or bad faith of an intra-family sale, deception could obviously be practiced by a buying spouse's agreement or tacit readiness to hold the property sold at the disposal of a selling spouse, rather more easily than by a pretense of a sale where none actually occurred, or by an unfair price. The difficulty of determining the finality of an intra-family transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of § 24(b).

It is clear, however, that this difficulty is one which arises out of the close relationship of the parties, and would be met whenever, by prearrangement, one spouse sells and another buys the same property at a common price regardless of the mechanics of the transaction. Indeed, if the property is fungible, the possibility that a sale and purchase may be rendered nugatory by the buying spouse's agreement to hold for the benefit of the selling spouse, and the difficulty of proving that fact against the taxpayer, are equally great when the units of the property which the one buys are not the identical units which the other sells.

Securities transactions have been the most common vehicle for the creation of intra-family losses. Even if we should accept petitioners' premise that the only purpose of § 24(b) was to meet an evidentiary problem, we could agree that Congress did not mean to reach the transactions in this case only if we thought it completely indifferent to the effectuality of its solution.

Moreover, we think the evidentiary problem was not the only one which Congress intended to meet. Section 24(b) states an absolute prohibition—not a presumption—against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that

their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.

The pertinent legislative history lends support to this inference. The Congressional Committees, in reporting the provisions enacted in 1934, merely stated that "the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax," and that these provisions were proposed to "deny losses to be taken in the case of [such] sales" and "to close this loophole of tax avoidance." Similar language was used in reporting the 1937 provisions. Chairman Doughton of the Ways and Means Committee, in explaining the 1937 provisions to the House, spoke of "the artificial taking and establishment of losses where property was shuffled back and forth between various legal entities owned by the same persons or person," and stated that "these transactions seem to occur at moments remarkably opportune to the real party in interest in reducing his tax liability but, at the same time allowing him to keep substantial control of the assets being traded or exchanged."

We conclude that the purpose of § 24(b) was to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted.

We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished. Congress, with such purpose in mind, could not have intended to include within the scope of § 24(b) only simple transfers made directly or through a dummy, or to exclude transfers of securities effected through the medium of the Stock Exchange, unless it wanted to leave a loophole almost as large as the one it had set out to close.

Petitioners suggest that Congress, if it truly intended to disallow losses on intra-family transactions through the market, would probably have done so by an amendment to the wash sales provisions,† making them applicable where the seller and buyer were members of the same family, as well as where they were one and the same individual. This extension of the wash sales provisions, however, would bar only one particular means of accomplishing the evil at which § 24(b) was aimed, and the necessity for a comprehensive remedy would have remained.

Nor can we agree that Congress' omission from § 24(b) of any prescribed time interval, comparable in function to that in the wash sales provisions, indicates that § 24(b) was not intended to apply to intra-family transfers through the Exchange. Petitioners' argument is predicated on the difficulty which courts may have in determining whether the elapse of certain periods of time between one spouse's sale and the other's purchase of like securities on the Exchange is of great enough importance in itself to break the continuity of the investment and make § 24(b) inapplicable.

Precisely the same difficulty may arise, however, in the case of an intra-family transfer through an individual intermediary, who, by pre-arrangement, buys from

† § 1091 of the 1954 Code, which re-enacts §§ 118 and 113(a)(10) of the 1939 Code. [Ed.]

one spouse at the market price and a short time later sells the identical certificates to the other at the price prevailing at the time of sale. The omission of a prescribed time interval negates the applicability of § 24(b) to the former type of transfer no more than it does to the latter. But if we should hold that it negated both, we would have converted the section into a mere trap for the unwary.[2]

Petitioners also urge that, whatever may have been Congress' intent, its designation in § 24(b) of sales "between" members of a family is not adequate to comprehend the transactions in this case, which consisted only of a sale of stock by one of the petitioners to an unknown stranger, and the purchase of different certificates of stock by the other petitioner, presumably from another stranger.

We can understand how this phraseology, if construed literally and out of context, might be thought to mean only direct intra-family transfers. But petitioners concede that the express statutory reference to sales made "directly or indirectly" precludes that construction. Moreover, we can discover in this language no implication whatosever that an indirect intra-family sale of fungibles is outside the statute unless the units sold by one spouse and those bought by the other are identical. Indeed, if we accepted petitioners' construction of the statute, we think we would be reading into it a crippling exception which is not there....

Affirmed.

MR. JUSTICE BURTON took no part in the consideration or decision of these cases.

Note

1. Does the buying spouse get a deduction when he or she sells to a third party? See § 267(d), which is new in the 1954 Code, *cf.* Note 2 of *McWilliams* case.

2. May one spouse sell securities to the other at cost in order to allow the transferee to take the gain or loss on a later sale to an outsider?

3. Section 267 disallows losses; it does not exempt gain. Suppose *A* buys a vacant city lot for $5000 and during a boom buys an identical adjacent lot for $15,000. Later he sells the lots to his wife for a price of $10,000 each, the market value at that time. For tax purposes, does he break even or have a gain of $5000? See *Morris Investment Co.* v. *Commissioner*, 156 F.2d 748 (3d Cir. 1946).

4. Section 267 is not exhaustive; loss may be disallowed if the transaction is devoid of economic reality even though the vendee is not in the prohibited group. *Crown Cork International Corp.* v. *Commissioner*, 4 T.C. 19 (1944), aff'd. *per curiam*, 149 F.2d 968 (3d Cir. 1945); *cf. Higgins* v. *Smith*, 308 U.S. 473 (1940); *DuPont* v. *Commissioner*, 118 F.2d 544 (3d Cir. 1941).

Section D. Income-Splitting Among Corporations

***Note:* Section 45 of the 1939 Code, authorizing the government to allocate income, deductions, etc. among related taxpayers to**

[2] We have noted petitioners' suggestion that a taxpayer is assured, under the wash sales provisions, of the right to deduct the loss incurred on a sale of securities, even though he himself buys similar securities thirty-one days later; and that he should certainly not be precluded by § 24 (b) from claiming a similar loss if the taxpayer's spouse, instead of the taxpayer, makes the purchase under the same circumstances We do not feel impelled to comment on these propositions, however, in a case in which the sale and purchase were practically simultaneous and the net considerations received by one spouse and that paid by the other differed only in the amount of brokers' commissions and excise taxes.

reflect income clearly, is re-enacted by § 482 of the 1954 Code.

Sections 129 and 15(c) of the 1939 Code, relating to corporate acquisitions or transfers to avoid taxes, are carried over in principle, with some modifications, by §§ 269 and 1551 of the 1954 Code.

See Regs. 118, Secs. 39.45-1, 39.15-2, and 39.129-1-4.

Since corporate income tax rates are not as steeply progressive as the individual income tax rates, there is less to be gained by the splitting of income among affiliated corporations. For 1954, the corporation must pay a normal tax of 30 per cent and, on its income in excess of $25,000, a surtax of 22 per cent. Sections 11(b) and 11(c) (The normal tax and surtax are imposed on the same base, except that "partially tax-exempt interest" is subject to the surtax but not to the normal tax.) If business income of $50,000 can be divided equally between two corporations, the additional surtax exemption of $25,000 will save the group $5,500 in taxes, *i.e.*, 22 per cent of $25,000. If a business income of $1,000,000 is similarly divided between two corporations, precisely the same saving, $5,500, will result. Splitting $1,000,000 of income equally among forty corporations, however, would result in a saving of $214,500, since 40 surtax exemptions, instead of only one, would be allowed.

Corporate income can often be split by having separate corporations carry on different branches of an enterprise: a factory may be owned by a real estate corporation, which leases it to a second corporation engaged in manufacturing; the latter may buy its supplies from a third corporation and in turn sell its manufactured goods to one or more sales corporations, all corporations being under common control. A combination of corporate and individual or partnership activity is also possible. Within limits, a division of income by such means is possible. The student should examine § 482, authorizing the Commissioner "to distribute, apportion, or allocate gross income, deductions, credits or allowances" among any two or more taxable entities that are under common ownership or control so as "clearly to reflect the income" of such entities. Section 482 has been the Commissioner's principal weapon where transactions between two related business units are manipulated for tax purposes, *e.g.*, sales at artificial prices to increase the income or losses of one of the entities in an arbitrary fashion.

There are two other statutory provisions that the Commissioner may employ to combat income-splitting and similar practices among corporations:

(a) Section 1551, enacted in 1951 and still relatively untested. Note the conditions that will bring § 1551 into play. It is not applicable if money, rather than property, is transferred. When applicable, § 1551 denies the $25,000 surtax exemption to the transferee corporation. How effective is the limitation likely to be? Emmanuel, "Section 15(c). New Teeth for the Reluctant Dragon?" 8 *Tax L. Rev.* 457 (1953).

(b) Section 269 is another safeguard against tax-motivated corporate transactions See *infra*, Chapter 6, Section B.

While primary attention is now being directed to income-splitting by the use of subsidiary and affiliated corporations, the student should recognize that sometimes an enterprise that is carried on through a complex of separate corporations may prefer to disregard all intra-family transactions and report its income on a consolidated basis. A simple illustration may make the problem clear. Assume

Corporation *A* owns both *B* and *C*, that *B* manufactures widgets and sells them at current wholesale prices to *C*, which sells them to the public. *B* and *C* both distribute part of their profits as dividends to *A*. In any given year, *B* may be operating at a profit while *C* is operating at a loss, and some or all of the dividends paid by *B* to *A* may represent intra-company, rather than "real," profits.*

By filing a consolidated return,† as authorized by § 1501, the corporate group will be taxed only on the profits represented by its transactions with the outside world. In effect, *C*'s loss is offset against *B*'s gain, and the dividends paid to *A* by *B* and *C* are disregarded. The group is treated as a single entity, so that only one surtax exemption is allowed; moreover, the surtax rate is 2 per cent higher (for 1954, 24 per cent instead of the usual 22 per cent) for the privilege of filing the consolidated return. Once a consolidated return has been filed, the group must continue to report on a consolidated basis, unless (1) a new corporation (other than one organized or created by a member of the affiliated group) becomes a member of the group, (2) the Commissioner consents to the use of separate returns, or (3) the statute or regulations are amended so as to make consolidated returns less advantageous to affiliated groups as a class. See Hellerstein, "Consolidated Federal Income Tax Returns," 5 *Amer. U. Tax Inst. Lectures* 415 (1953).

ADVANCE MACHINERY EXCHANGE, INC. v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1952
196 F.2d 1006

Before CHASE, BIGGS and CLARK, Circuit Judges.

CHASE, Circuit Judge.

The Tax Court affirmed a deficiency assessment in the declared value excess profits taxes and excess profits taxes of the petitioner for the year 1942 on the ground that amounts of income reported by other taxpayers were properly allocable to the petitioner under §§ 45 and 22(a), I.R.C. . . .

*By reason of the dividends-received deduction of § 243(a), *A* would ordinarily be taxed on only 15 per cent of the dividends received from *B*, but even this amount may exceed the "real" profits of the whole group

† Consolidated returns can be filed only if all included corporations consent Does the management of a corporation that can bring a tax loss to the consolidated return have a fiduciary obligation to its minority stockholders or creditors to demand a *quid pro quo*? Mr Justice Jackson had this to say (in a dissenting opinion) of an action brought by a subsidiary corporation's receiver against the parent corporation for unjust enrichment in "appropriating" the subsidiary's tax loss for use on a consolidated return, with a savings to the parent of $17,000,000 in taxes "Each of these corporations had something to contribute to a tax-saving plan. . . It was as if a treasure of seventeen million dollars were offered by the Government to whomever might have two keys that would unlock it. Each of these parties had but one key, and how can it be said that the holder of the other key had nothing worth bargaining for? The management, probably without improper intent, failed to claim for the plaintiff the advantages of its position, turning them over without compensation for the advantage and profit of another affiliated corporation. On the face of it, the conclusion would seem to be warranted that the plaintiff is entitled to what fair arm's-length bargaining would probably have yielded." (Western Pacific R. R Corp. v. Western Pacific R R Co, 345 U.S. 247, 276-7 (1953)) The Court of Appeals had the last word, however, and the petition was dismissed "How could this court or the district court determine 'what fair arm's-length bargaining would probably have yielded.' Bargaining presupposes negotiations to determine the maximum amount a buyer is willing to pay and the minimum amount a seller is willing to accept Such activity is a matter of business administration, and is not a judicial function" (Western Pacific R. R Corp v Western Pacific R R. Co, 206 F.2d, 495, 499-500 (9th Cir 1953).)

Whether the Tax Court was correct in allocating income to the petitioner under § 45, I.R.C. is essentially one of fact and the decision below must be affirmed if supported by substantial evidence. . . . Section 45 [§ 482, 1954 Code] provides.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income . . . between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Tax Court found that the petitioner was organized in 1928 by one Joseph Blachman to deal in used machinery. Subsequently, the Blachman Machinery Company, Inc. and the Awon Holding Corporation were formed, and, in 1939, Joseph Blachman proceeded to engage in this business individually. Joseph Blachman and his son, Seymour Blachman, were officers and directors of all of these corporations, did most of the buying and selling for each of the business enterprises, and they or their immediate families owned all of the stock in them. Each of the enterprises was conducted from the same office with the same employees, using the same equipment, and to a large extent supplying the same customers. The petitioner, however, carried on by far the largest part of this business. There was evidence that large numbers of purchase invoices had been altered to attribute them to one or another of these taxpayers and that these changes were made without any set policy to indicate that there was any motive in doing so other than to divert income from the petitioner. Typical of this shifting of income under the arrangement used was the fact that, in the last half of 1942, when Blachman Machinery Company, Inc. was inactive, and listed no employees in its Social Security returns for that period, the sales invoices indicated that it made 47 separate sales. Such evidence gave the Tax Court an adequate basis on which to find that:

All four businesses were controlled by J. Blachman and Seymour Blachman, father and son. The two operated the business and kept the books and records of all four businesses in such a way that the net profit of each could be manipulated as they saw fit, and, in general, so conducted the business that it is impossible to determine where the activities of one or the other begin and end.

And, in view of the extent to which this was done, to hold that

petitioner had not shown that respondent erred in attributing to it [all] the net income of the three other businesses, ...

The petitioner argues that if the formal tax entities are not to be charged with the income they each received, then, any attribution of income to another taxpayer under § 45 must be to Joseph and Seymour Blachman as individuals, and not to the petitioner, since these individuals controlled all four enterprises. However, as the Tax Court found,

The evidence is clear that petitioner served as the connecting link for the (business) conducted by these four entities and the outside customers.

This conclusion is supported by substantial evidence. The petitioner's contention, therefore, indicates a misconception of the purpose served by § 45. It was not these two individuals who, in fact, earned all of the income reported by the four

enterprises any more than that would be true of the income of any closely held corporation. An individual

> is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages. (*Higgins* v. *Smith*, 308 U.S. 473, 477, 60 S. Ct. 355, 358, 84 L. Ed. 406.)

While § 45 permits the Commissioner to reallocate income, it does not permit him to disregard valid tax entities altogether. Here, it was determined that there were four such entities but that only one, in fact, earned the income which was divided among all four and that one was the petitioner. Consequently, it is the taxpayer to whom the income in question was properly allocated.

We need not decide whether what the Commissioner did is sustainable under § 22(a), I.R.C. alone, *cf. Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75; *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731; *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, since we think § 45 is applicable to this situation despite the petitioner's contention that what the Commissioner has done amounts to a consolidation of the income of the various entities as under § 141(d), I.R.C. [§ 1501, 1954 code] in violation of Regulation 118, § 39.45–1(b).[1]

At first blush, this regulation would seem to support the petitioner's position but analysis shows the contrary. The effect of such an interpretation would be to exclude from the applicability of § 45 fact situations like the present one if the separate entities involved were all corporations and the Commissioner had sought to allocate all of the income from each to one of them, since this "would produce a result equivalent to a computation of consolidated net income under § 141." It may, perhaps, be sufficient for the present to point out that what was done is not, strictly, equivalent to a consolidation under § 141 since, under that section, only the income of affiliated corporations may be consolidated while here the income of a sole proprietorship was included. However, we do not rely entirely upon this distinction. Whatever valid interpretation may be given this regulation, the unsoundness of that of the petitioner is illustrated by the fact that it would exclude from the "policing" provisions of § 45 the most flagrant evasion by arbitrary shifting of income. It would let the Commission reallocate the income of these separate entities, to reflect the income of each correctly, if the amount involved, however great, did not equal their total combined income but he could not apply § 45 at all if the taxpayers succeeded in constructing a situation where, in order to prevent tax evasion or properly to reflect income, it were necessary to attribute all of the income of the separate entities to one of them, as was done here. Thus tax evasion could be so complete as to make itself invulnerable, a proposition whose statement discloses its fallacy.

Our opinion in *Asiatic Petroleum Co. (Delaware), Ltd.* v. *Commissioner of I. R.*, 79 F.2d 234, and that of the Third Circuit in *National Securities Corp.* v. *Commissioner of I. R.*, 137 F.2d 600, indicate clearly that the purpose of § 45 is to prevent tax evasion by any arbitrary shifting of gross income among businesses owned or controlled by the same interests. See 8 Merten's, *Law of Federal Tax-*

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[1] "(Section 45) is not intended . . . to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under § 141."

ation, § 46.69. There is no exception, nor any reason for excepting, from this purpose the case where such arbitrary allocation of income is among affiliated corporations who could, under § 141, consolidate their respective incomes. Furthermore, subdivision (1) of § 141 contains this language: "For allocation of income and deductions of related trades or businesses, see section 45." We interpret this subdivision to mean that, although the Commissioner is not free to require affiliated corporations to consolidate their incomes, he may allocate the income among them if they are engaged in "related trades or businesses" and "if it is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations" just as he may do that in respect to other taxpayers and do so to whatever extent that may be necessary to accomplish the purpose of that section....

Affirmed.

COMMISSIONER v. CHELSEA PRODUCTS, INC.

U. S. Court of Appeals, Third Circuit, 1952
197 F.2d 620

Before McLaughlin, Staley and Hastie, Circuit Judges.

Staley, Circuit Judge.

The Commissioner of Internal Revenue has petitioned for a review of two decisions of the Tax Court. The principal issue presented is whether Section 45 of the Internal Revenue Code, . . . authorizes the Commissioner to combine the net income of three corporations with that of taxpayer where all are owned by the same interests. We are in accord with the Tax Court's conclusion that Section 45 was erroneously applied.

Between 1941 and 1944, taxpayer was engaged in the manufacture and sale of fans and blowers under the name of Chelsea Fan & Blower Co., Inc. During this period the sole stockholders, officers, and directors of taxpayer were William J. Lohman, Sr., who held 50% of the common stock outstanding, and his two sons, Eugene W. and William J., Jr., each of whom held 25%.

In 1944 the three Lohmans, after consultations with their attorney, decided to separate taxpayer's manufacturing functions from its sales. The new plan was carried out by forming a sales corporation in each of three states: Missouri, Georgia, and New Jersey. These new corporations bore the respective names Chelsea Fan and Blower Company of Missouri, Chelsea Fan & Blower Company of Georgia, and Chelsea Fan and Blower Co., Inc. Each of the sales companies issued 1200 shares of stock at $1 a share, which was subscribed to in equal amounts by each of the three Lohmans. As in the case of taxpayer, the three Lohmans constituted the Board of Directors of each of the sales companies during the taxable years involved. At the same time, the taxpayer changed its name to Chelsea Products, Incorporated, and thereafter confined its activities principally to manufacturing.

Prior to the creation of the new corporate structure in 1944, taxpayer had sold its products through its officers and through "manufacturer's agents." Taxpayer had entered into contractual arrangements with these agents whereby they were

paid commissions of about 10% on sales. After July 11, 1944, taxpayer no longer employed these manufacturer's agents. On that date the sales companies were designated exclusive agents, each company being assigned a different area of the country, and they in turn proceeded to employ sales agents. The arrangements between taxpayer and the sales companies were formalized by written agreements entered into between taxpayer and each sales company. These agreements, signed by William J. Lohman as president of taxpayer and Eugene W. Lohman as vice president of the sales companies, provide that each sales company is to "employ a sufficient number of salesmen to properly canvass its territory" and is to be charged the list price less 50% and 25%. The former discount was the standard one given by those in the industry to wholesale jobbers and was passed on to the wholesale jobbers who bought the products. The 25% discount, the Tax Court found, includes the 10% commission normally paid to the agent, thus leaving 15% for the operation of the business of the sales companies.

Although the Missouri and Georgia companies had mailing addresses in their respective states of incorporation, neither had an office there. Each of the sales companies maintained its office in New Jersey at 1206 South Grove Street, Irvington—the same address which had been occupied by taxpayer. Each of the companies had separate books and records and separate bank accounts. The records of the sales companies were kept by the same bookkeeper who kept taxpayer's books and were audited by an outside accounting firm.

During the taxable years involved, all the fans and blowers sold by the sales companies were manufactured by taxpayer. A sales agent, upon receiving an order, would send it to Irvington, N. J., to the sales company which employed him. The order was then turned over to taxpayer which shipped the merchandise directly to the customer and invoiced the sales company. The latter, in turn, submitted an invoice to the customer and received payment from him.

The business reasons which prompted the organization of the sales companies are set forth in the record. The attorney whom the Lohmans consulted in 1944 testified that he had advised them that taxpayer's tort liability arising from accidents in the use of the fans could thereby be "minimized." The record also reveals that the Lohmans had intended that the sales companies establish assembly plants in several states in order to reduce freight costs. Further, the Lohmans believed that sales, especially in the South, would be increased if promoted by a local firm.

The Commissioner determined that there was a deficiency of $110.58 in taxpayer's income tax liability and $37,091.85 in its excess profits tax liability for the year 1944. He also determined that there was a deficiency of $165.62 in its income tax liability and $25,519.13 in its excess profits tax liability for the year 1945. In arriving at these deficiencies, the Commissioner allocated the net income of the three sales companies to that of taxpayer. The latter then sought a redetermination before the Tax Court. The Tax Court found that each sales company was a business enterprise separate and distinct from taxpayer and that no part of the income of the sales companies constituted income to it. Moreover, that Court determined that the principal purpose for the organization of the sales companies was to carry on business and not to aid taxpayer in evading or avoiding Federal income or excess profits taxes. The Tax Court, five judges dissenting, held that the Commissioner's action was not authorized.

The Commissioner asserts that he acted within the broad discretionary power conferred upon him by Section 45, which section reads.

> Allocation of income and deductions. In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate *gross income*, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. (Italics supplied.)

Section 45 has been a part of our Revenue Laws since 1928.[1] It is in some sense an offspring of Section 240(f) of the Revenue Act of 1926, which gave the Commissioner the right to consolidate the accounts of business controlled by the same interests where he finds it necessary to make an accurate distribution of profits and deductions. Section 240(f) was a part of the Consolidated Returns section of the 1926 Act. In drafting the new Section 45, important changes were made and, significantly enough, the offspring became a new section, separate and apart from the Consolidated Returns section.

Section 45 grants to the Commissioner power to allocate "gross income, deductions, credits, or allowances." There is no mention of authority to disregard completely the corporate entity by combining the net income of controlled corporations. The plain language of Section 45 must prevail.

The scope and purpose of Section 45 is clearly set forth in the Treasury Regulations. Treasury Regulation 118, § 39.45–1(b) states:

> The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. . . . It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.

The Report of the House Ways and Means Committee states that the evil for which Section 45 was designed was the arbitrary shifting of profits from one corporation to another by such devices as fictitious sales. House Rep. No. 2, 70th Cong., 1st Sess., p. 16.

Both the Treasury Regulation and the Committee Report clearly delineate the scope of Section 45. This section authorizes the Commissioner to scrutinize all transactions between controlled corporations. His object is to arrive at the true net income of each controlled taxpayer and the technique used is the application of the standard of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Whenever the lack of an arm's length relationship produces a different economic result from that which would ensue in the case of two uncontrolled taxpayers dealing at arm's length, the Commissioner is authorized to allocate gross income and deductions.

Section 45, based upon a recognition of the various corporate entities, merely

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[1] The section has remained unchanged since 1928 except for a minor amendment in 1944. Act of February 25, 1944, c. 63, Title I, § 128(b), 58 Stat. 48.

allows the Commissioner to prevent distortions in income between controlled corporations. In fact, the Treasury Regulation itself states that Section 45 is

> not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions . . . as would produce a result equivalent to a computation of consolidated net income under § 141.

The Commissioner, in disregarding the corporate entities of the sales companies and lumping together all net incomes, has proceeded beyond his statutory bounds.[2]

The dissenting judges in the Tax Court were of the opinion that the allocation of net income was a shorthand way of allocating that portion of the gross income of the sales companies which exceeded their deductions. We cannot accept this approach. In fact, this argument points up a second error underlying the manner in which the Commissioner proceeded. The notices of deficiency in the instant cases merely state that given amounts alleged to represent the net income of the sales companies represent net income taxable to taxpayer. The notices contain no indication whatsoever that the Commissioner made his determination under Section 45. Moreover, the petitions and answers in these cases raise no issue with respect to the application of this section. See *Burrell Groves, Inc.*, 16 T.C. 1163 (1951), acq. 51-2 I.R.B. 2; *Palm Beach Aero Corp.*, 17 T.C. 1169.

The deficiency notices were thus deceptive and gave taxpayer no notice that the Commissioner was proceeding under Section 45. Since Section 45 grants the Commissioner discretionary powers the burden falls upon the taxpayer to prove that the Commissioner's determination is arbitrary. *G.U.R. Co.* v. *Commissioner*, 7 Cir., 1941, 117 F.2d 187, 189; *National Securities Corp.* v. *Commissioner*, 3 Cir., 1943, 137 F.2d 600, 602, certiorari denied 1943, 320 U.S. 794, 64 S. Ct. 262,

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[2] The Court of Appeals for the Second Circuit has recently handed down its decision in Advance Machinery Exchange, Inc. v. Commissioner of Internal Revenue, 2 Cir., 196 F.2d 1006. The taxpayer there was organized by one Blachman to deal in used machinery. Subsequently, two corporations (which we denominate A and B) were formed to engage in the same business and Blachman proceeded to engage in the same business individually. All four businesses were controlled by Blachman and his son. All the entities conducted their businesses at the same office and all used the identical employees and equipment. Each enterprise had many customers in common. In contrast to the instant case, *there was no separation of business functions* as among the four enterprises. The Tax Court's conclusion is well expressed in the following statement in its opinion: "All four businesses were controlled by J. Blachman and Seymour Blachman, father and son The two operated the business and kept the books and records of all four businesses in such a way that the net profit of each could be manipulated as they saw fit, and, in general, so couducted the business that *it is impossible to determine where the activities of one or the other begin and end*" (Italics supplied)

The Commissioner allocated the net income of Corporation A, Corporation B, and Blachman individually to the taxpayer, relying on both § 22(a) and § 45 of the Internal Revenue Code. The Tax Court, 8 T.C M. 84 (1949), held that the Commissioner's determination was proper under the broad scope of § 22(a) but was silent on the applicability of § 45. The Tax Court was clearly of the opinion that the three enterprises other than taxpayer were mere shams The Tax Court concluded with the following words "*In reality, therefore, there is but one taxable entity, the petitioner, and all of the income of the business is attributable to it*" (Italics supplied) The finding is thus in marked contrast with the Tax Court's finding in the case at bar that each of the sales companies was a business enterprise separate from the taxpayer and that the principal purpose for their organization was to carry on business

In affirming the decision of the Tax Court, the Court of Appeals for the Second Circuit relied on § 45 rather than § 22(a). We consider the Court's observation with respect to § 45 to be essentially dicta, for, since the Tax Court had determined that there was but one taxable entity, all the net income was necessarily taxable to taxpayer under § 22(a).

88 L. Ed. 479. This considerable power given the Commissioner certainly carries with it a correlative duty to give the taxpayer fair notice in advance of hearing that the Commissioner has proceeded under Section 45. The taxpayer can hardly shoulder its burden if it does not know the Commissioner has proceeded under Section 45 or if it does not know which transactions or group of transactions the Commissioner has determined to have resulted in distortions of true net income.

The Commissioner asserts that his determination is also warranted by Section 129 [§ 269, 1954 Code], the pertinent portion of which is as follows

Acquisitions made to evade or avoid income or excess profits tax. (a) Disallowance of deduction, credit, or allowance. If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. . . . (b) Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized— (2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, ...

The Commissioner relies specifically on Subsection (b)(2) of the Section. Like Section 45, it speaks in terms of allocating "gross income, deductions, credits, or allowances." Hence there is certainly a real doubt as to whether the Commissioner has properly proceeded under this section. We need not decide this point, however, for the Tax Court has found as a fact that the principal purpose of the organization of the sales companies was to carry on business and not to aid in the evasion or avoidance of Federal income or excess profits taxes. We cannot say that this finding of fact is clearly erroneous. See *Chester Distributing Co.* v. *Commissioner*, 3 Cir., 1950, 184 F.2d 514. On the contrary, we think it is supported by substantial evidence.

For the above reasons, the decisions of the Tax Court will be affirmed.

TWIN OAKS CO. v. COMMISSIONER

U. S. Court of Appeals, Ninth Circuit, 1950
183 F.2d 385

Before MATHEWS, BONE and LINDLEY, Circuit Judges.

LINDLEY, Circuit Judge.

This is a petition to review a decision of the United States Tax Court sustaining the assessment of income taxes against the corporate petitioner for the years 1941–44 inclusive.

Prior to January, 1941, the Petitioner had, for many years, been engaged in the purchase and sale of builders' materials. During all this period the business had been managed by Rogers, who, with 473 shares of the corporate stock, was the corporation's principal stockholder, and Scharpf, who held 35.3 shares and whose wife owned the remaining 437.7 shares. In January, 1941, after the corporation had for some time realized unsatisfactory profits, pursuant to a plan suggested by Scharpf and, after some opposition, agreed to by Rogers, the latter and his wife

and Scharpf and his wife executed a partnership agreement whereby the four, as equal partners, were to take over the business of the corporation, purchasing its operating assets and leasing from it the real estate on which the business had been and was then being conducted. The two men were to continue to manage the business; each was to receive an annual salary of $6,600 in addition to one-fourth of the partnership profits, their wives were to furnish lesser services for which they were to receive salaries of $300 per annum each.

Petitioner, in consideration of the assumption by the partnership of the corporation's accounts payable and of the partnership's promissory note in an amount which, added to the liabilities assumed, equalled the book value of the petitioner's assets other than real estate, transferred to the partnership all its assets except the premises on which the business had been and was thereafter to be conducted, which land it leased to the partnership for an annual rental of $3000. Each of the four partners contributed $2000 in additional capital. Petitioner caused its corporate name to be changed from Twin Oaks Builders Supply Company to Twin Oaks Company, and the partnership, after registration with proper public authorities, engaged in business under the name by which petitioner had formerly been known. The corporation and the partnership thereafter maintained different and separate sets of books, records and bank accounts.

In the years 1941–44, petitioner's income, duly reported, included only (1) the rent received from the partnership under the lease, (2) the interest paid by the partnership on its note, and (3) a few petty miscellaneous items. The Commissioner asserted tax deficiencies against the corporation on the theory that the partnership had been created solely as a device improperly to effectuate reallocation of income among family groups to defeat taxes and, hence, that the profits of the partnership, reported in the individual returns filed by Rogers and Scharpf and their wives, were properly taxable to petitioner. A single-judge Tax Court sustained the deficiency assessments, agreeing with the Commissioner that the creation of the partnership and the transfer to it of petitioner's operating assets had been "forms without substance" which were not entitled to recognition, in so far as taxes were concerned.

It is, as the Tax Court observed, well settled that a taxpayer is free to adopt such legal organization for the conduct of his affairs as he may choose; he may convert from the corporate method to the partnership method of doing business and, though his motive in so doing be to reduce taxes, the conversion must be accorded recognition unless it is such a sham, such a change in form only, without substance, as to require that it be disregarded for tax purposes. *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788. It seems clear to us, however, that the Tax Court, in its characterization of the change in business structure involved in the instant case as a sham and a mere form without substance, has, in effect denied the taxpayers the legal right to conduct their business affairs through a medium of their own choice.

There can be no doubt that it was the intent of the parties that the partnership should thereafter conduct the supply business which, prior to the formation of the partnership, had been conducted by petitioner; that the partnership was actually formed; that petitioner's stockholders were, as members of the partnership, subjected to unlimited personal liability not only for the old corporate debts but also for any which might grow out of the operation of the business thereafter by the

partnership, in place of the limited liability to which they had previously been subject, and that the profits of the business were not thereafter distributed among the partners in proportion to their respective holdings of stock in the corporate petitioner. These changes, all made without thought of or intent to achieve tax advantages, were, we think, far more than mere changes in form. The Tax Court felt that the fact that profits were distributed in a different manner and in different proportions, but to the same people, indicated that the changes were formal only. The logic of this position escapes us, for it ignores the reality of the conversion from corporate to partnership operation of the business and tends in no way to show that the corporation, rather than the partnership, earned the income.

It seems obvious that if petitioner's affairs had been completely liquidated, the income in question would necessarily have been regarded as earned by the partnership. The mere fact that the parties stopped one step short of liquidation, i.e., kept the corporation alive for the sole purpose of holding title to the real estate, while selling and transferring the operating business itself to the partnership, does not, we believe, detract from the reality or substance of what was done or require that all the income of the business be taxed to petitioner. As a matter of fact, the decision of the Tax Court itself, in such cases as *Seminole Flavor Co.*, 4 T.C. 1215; *Buffalo Meter Co.*, 10 T.C. 83, and *Miles-Conley Co.*, 10 T.C. 754, would seem to impel a decision that the partnership was entitled to full recognition for tax purposes even though the corporation continued to exist and to function in a rather close relationship with it. The Tax Court sought to distinguish these cases by saying that the businesses involved therein were capable of being broken down into distinct divisions, whereas the builders supply business was "unitary in character," but it certainly could be and was easily separated from the real estate and was thereafter conducted solely by the partnership.

We conclude that the Tax Court erred in sustaining the Commissioner's deficiency assessments against petitioner. The decision is reversed.

CHAPTER 5

CAPITAL GAINS AND LOSSES

Section A. Introductory

SELTZER
THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES *

National Bureau of Economic Research (1951), pp. 3-5, 8-12
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Capital gains vs. ordinary profits

In both law and common speech, capital gains are generally regarded as the profits realized from increases in the market value of any assets that are not a part of the owner's stock-in-trade or that he does not regularly offer for sale, and capital losses, as the losses realized from declines in the market value of such assets. *Ordinary* profits and losses, in contrast, are realized on the sale of goods and services that *are* a part of the seller's stock-in-trade or that he regularly offers for sale. The profit earned by a manufacturing company through the operation of its plants and machinery may be contrasted with the gain it would make if it sold some of its investment securities for more than they had cost it. The former is an ordinary business profit, the latter a capital gain.

Ordinary profits are commonly the result of buying goods in one market and selling them in another, that is, in a different form, in different quantities, at a different season, or in a different place. The manufacturer earns ordinary profits by converting raw materials and semifinished goods into new forms, which he sells to other manufacturers, wholesalers, retailers, or consumers. The wholesaler buys in large quantities from the manufacturer and relieves the latter of the task of finding and supplying scores of retail outlets. The retailer earns ordinary income by buying his wares from wholesalers, jobbers, and manufacturers, and selling them to his customers in much smaller unit-quantities, together with packaging, and perhaps delivery and credit services. Capital gains or losses, on the other hand, are most commonly the result of changes in prices in the same market. They are realized most characteristically when one investor or speculator sells his holdings to another. The profit made by a real estate company that buys raw acreage, subdivides it into streets and building lots, and sells plots, is regarded as an ordinary business profit; but the gain made by the farmer or long term specu-

* Reviewed by Slitor, 5 *Nat'l Tax J.* 178 (1952). [Ed.]

lator who sells the acreage to the real estate company, or by the factory worker who purchases a single lot and subsequently resells it, is regarded as a capital gain.

The major sources of capital gains and losses are capital assets; that is, property acquired for income-making rather than consumption purposes—corporation securities, real estate, government bonds, and interests in partnerships, leases, and contracts. In 1936, the only year for which the relevant data are available, approximately four-fifths of the aggregate net capital gains reported on federal income tax returns were derived from stocks and bonds. In the broadest sense, personal and other nonbusiness possessions such as jewelry, paintings, and houses may also give rise to capital gains and losses. During World War II and the period immediately following, many persons were able to sell automobiles, houses, cameras, and certain other articles they had previously purchased for their own use at much higher prices than these goods had cost them. The United States recognizes capital gains so derived and taxes them as such, but it does not allow deductions from taxable income for losses sustained on assets not acquired for a 'gainful,' i.e., money-making purpose....

Distinction between capital gains and ordinary income often blurred

While the broad distinction we have made between capital gains and ordinary profits is useful in a general way, it cannot be pressed far for purposes of either economic analysis or law. As we shall find upon further examination, ordinary business profits often contain large amounts of what are essentially capital gains, while large amounts of so-called capital gains are little or no different from ordinary profits, or arise indirectly from the accumulation of ordinary income.

Moreover, although the general distinction offers a rough guide to the legal concept of capital gains and losses, the effective legal definition has varied from time to time in the United States and in other countries. The profits and losses arising from short term transactions in capital assets, for example, have frequently been excluded from the legal category of capital gains and losses. In addition, the dividing line between short and long term transactions has at different times been 24, 18, 12, and 6 months in the United States. In Sweden the dividing line is 10 years for real estate and 5 years for other capital assets. The point at which the owner of any kind of capital assets ceases to be merely an investor and becomes, in the eyes of the law, engaged in buying and selling them (and his capital gains become, for tax purposes, ordinary profits), is by no means always clear and has been the subject of much litigation. What constitutes 'realization' has also been altered by the statutes and courts from time to time. The legal form of the transaction rather than its substance is sometimes decisive. The successive changes in the statutory definition of capital assets in the United States are described briefly at the end of this chapter....

3. ARE CAPITAL GAINS INCOME?

Whether capital gains should be taxed as ordinary income, taxed at lower rates, or excluded from taxable income has been the subject of more or less continuous controversy in the United States.† In favor of taxing capital gains like ordinary in-

† The constitutionality of taxing capital gains was settled, after some uncertainty, in 1921, when the Supreme Court decided Merchants' Loan & Trust Co. v. Smietanka, 255 U. S 509, 520-521 (1921): "It is elaborately argued in this case . . . that the word 'income' as used in the

come it has been argued that they produce an equal increase in an individual's economic power· the ability to command economic resources and direct them into channels of his own choosing. Like ordinary income, realized capital gains may be spent or saved. Used for consumption, they enhance the ability of a man to build or buy a bigger house, to give his family more expensive clothes, food, and amusements, and to provide his children with superior educational opportunities. As savings, capital gains can be converted into bank balances, bonds, stocks, and other titles to wealth in precisely the same manner and degree as wages and salaries, interest, rent, and ordinary profits. Even when capital gains have not yet been 'realized' by sale—while they are still in the form of paper profits, so-called—they constitute additions to the economic resources of those who enjoy them. For even in this form they supply approximately the same increase in economic power, excluding the effects of taxes, as an equal amount of wealth obtained by accumulating and investing ordinary income. In analogous ways, capital losses may be said to reduce the economic power of those who suffer them and, therefore, to be valid deductions from ordinary income.

But no less positive have been the protests of those who hold that capital gains and losses should be completely excluded from income tax on the ground that they are not true elements of income. Unlike most kinds of ordinary income, capital gains occur irregularly in the lives of most individuals. A prudent man does not consider them available for ordinary consumption purposes both because they cannot confidently be expected to recur and because they may well be followed by sporadic losses. A capital gain, therefore, is commonly regarded as a direct addition or accretion to a man's capital, not a part of his disposable income.

Moreover, capital assets derive their value from the incomes that are expected from them, and these incomes are subject to tax when received. A rise in the value of a capital asset often reflects merely a rise in the income expected from it. To tax both the increase in income when it is received and the rise in the market value which merely reflects this expected increase in income is really to tax the same thing twice, it is argued. Of course, the owner gives up the enlarged prospective income from the capital asset when he sells it to 'realize' his gain; but he will presumably reinvest the entire proceeds, minus taxes, at the going rate of return and will therefore continue to obtain and pay taxes on the enlarged income reflected by his capital gain.

Also, if we tax the seller's capital gain as income, are we not treating him unfairly as compared with the owner who does not sell but who equally enjoys the enlarged income?

Sixteenth Amendment . . does not include the gain from capital realized by a single isolated sale of property but that only the profits realized from sales by one engaged in buying and selling as a business—a merchant, a real estate agent, or broker—constitute income which may be taxed

"It is sufficient to say of this contention . that the definition of the word 'income' as used in the Sixteenth Amendment, which has been developed by this Court, does not recognize any such distinction . . and that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. The interesting and ingenious argument, which is earnestly pressed upon us, that this distinction is so fundamental and obvious that it must be assumed to be a part of the 'general understanding' of the meaning of the word 'income,' fails to convince us that a construction should be adopted which would, in a large measure, defeat the purpose of the amendment." See Magill, *Taxable Income* (rev. ed. 1945) 103–113. [Ed.]

Further, most capital gains arise over periods longer than 1 year, often many years. To treat them as the income of the single year in which they are realized subjects the recipient to a higher tax than would be payable on an equal amount spread over the number of years in which the gain developed.

Finally, to mention only one of several other aspects in which capital gains differ from ordinary income . . . , it is contended that capital gains do not represent as much taxpaying capacity as an equal amount of ordinary income because they are sporadic, as compared with the recurring character of most types of ordinary income.

The last two points can be illustrated by a comparison. The annual income of James Peters of Cleveland, Ohio hovered about $3,000 for many years. In 1951, besides his ordinary income of $3,000, he realizes a capital gain of $15,000 by selling the house he bought 30 years before to a company that plans to erect an automobile service station on the land. Should Mr. Peters be taxed in 1951 as if his income were $18,000? Does his taxpaying capacity equal that of his sister whose 1951 income of $18,000 was derived wholly from $720,000 par value of 2½ percent Treasury bonds bequeathed her by her husband?

Powerfully supporting the view that capital gains and losses are not true elements of income has been the example of Great Britain, Canada, Australia, and most European countries with respect to capital gains realized by individuals outside the course of their ordinary business activities. A long tradition in European thought and law has excluded most casual and irregular gains, particularly from the sale of capital assets, from the prevailing concept of personal income and, therefore, from the taxable income of individuals. Besides the force of example, some of the same historical influences and logical considerations that produced this attitude in Europe have been influential in the United States.

But some capital gains are different only in form from ordinary income. An investor who buys a 30-year 3 percent corporation bond at 90 is actually getting an interest return of about 3.55 percent annually; but his return will take the *form* of an interest income of 3 percent a year and a capital gain of about $100 per $1,000 bond at maturity.‡

Reinvested corporate profits

Capital gains that appear to reflect the direct reinvestment of profits by corporations have raised an especially troublesome question. Because the law conceives a business corporation as an entity separate and distinct from its stockholders, corporate profits are not regarded as the income of the latter unless and until they receive them in dividends. Consequently, stockholders can postpone or avoid the ordinary personal income taxes upon their proportionate shares of retained corporate earnings. But if these retained earnings are profitably employed by the corporation, stockholders can reasonably expect to obtain some proportion of them—though often only a surprisingly small proportion—in the form of a capital gain taxable at a preferentially low rate when they sell the stock. Meanwhile, they can expect to enjoy a rise in the earning power and market value of their holdings. Even the capital gains tax will be avoided and the share of these stockholders in the accumulated earnings of the corporation will never be subjected to personal income taxes if they never sell the stock but leave

‡ See Commissioner v. Caulkins, *infra*, p 423. [Ed.]

it to their heirs § or give it away during their lifetimes to charitable or other tax-exempt institutions or to persons who leave it to *their* heirs. (Persons who sell property received by gift are subject to tax on the proceeds over the excess of the donor's cost or other basis.)

On the other hand, some reinvestment of earnings may be essential to enable an enterprise merely to maintain its competitive position and its earning power. Accounting charges for obsolescence are often absent or insufficient, with the consequence that the reported earnings often overstate what later are seen to have been the true earnings. Most individual shareholders in large corporations cannot expect to influence dividend policies greatly. They seldom regard their *pro rata* share in the undistributed earnings of their corporations as a part of their individual incomes. They cannot confidently expect their holdings to increase in market value by the exact amount of earnings reinvested on their behalf. Even if such an increase occurs, the stockholder may find it impracticable to convert it into disposable income by selling one or a few shares and regarding the enhanced market value of the remainder as a measure of the maintenance of the principal of his investment. The scale of brokers' commission charges makes the sale of a few shares of stock relatively expensive, and the market value of a single share may greatly exceed the amount of corporate earnings being reinvested on behalf of the remainder of the investor's holdings. For these and other reasons, the market is likely in many cases to appraise reinvested corporate earnings at less than face value. The question of the proper tax treatment of capital gains comes into contact at this point with the whole question of the tax treatment of corporate profits.

TAX ADVISORY STAFF, TREASURY DEPARTMENT FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES

(1951), pp. 9-10, 12-14, 21-22

The capital gain and loss provisions of the Federal taxes on individual and corporate income have been controversial since their enactment. Opinion concerning these provisions has ranged from one extreme, that capital gains and losses should be completely excluded from the bases for income taxation, to the other, that these gains and losses should be treated for tax purposes precisely like any other positive or negative elements of ordinary income.

Prior discussion regarding taxation of capital gains has devoted considerable attention to the question whether these gains are capital or income. Opponents of the tax state that capital gains are not income and therefore should not be subject to income tax. Proponents of capital gains taxation believe these gains are sufficiently indicative of taxpaying ability, at least when realized, to be properly subject to income tax.

Since 1922, Congress, while consistently upholding the general principle that capital gains are proper objects of income taxation, has followed an intermediate course in determining the rates of tax to be applied. Although varying in detail,

§ See § 1014. [Ed.]

this has included the following main characteristics: (1) Inclusion of capital gains and losses for tax purposes only when realized by sale or exchange; (2) application of special low tax rates to capital gains accrued over more than a minimum period prior to realization; and (3) limitations on deductibility of capital losses from ordinary income....

Basically, the problem of capital-gains taxation is difficult because of the realization criterion of taxability. Under this rule, the taxpayer himself determines when his gains and losses shall be brought to account. Thus taxpayers have the option to postpone tax liability simply by holding gains unrealized, i. e., by not selling or exchanging their appreciated property. Conversely, they can obtain immediate tax reduction (subject to the limitations already described) by the sale or exchange of capital assets on which losses have accrued. Tax considerations, therefore, reinforce the normal tendency of investors to take losses promptly while letting gains accumulate.

The aggregate of capital gains realized by sale or exchange in any given year will have accrued over a broad range of holding periods—from a few days to many years. There has been widespread acceptance of the general principle that it is unfair to tax at progressive rates, in a single year, capital gains which have accrued over a number of previous years. Concentration of such long accrued capital gains for tax purposes in the year of realization tends to push some taxpayers into higher rate brackets and to make effective tax rates on some gains higher than would have been the case had the taxpayer been allowed to apportion his gains back, either to the actual years of accrual or to some arbitrary period, such as 5 years. Preferential tax treatment for long-term capital gains has always been justified in part by this effect. However, the amount of tax preference given long-term gains has generally been substantially greater than the amount of tax rate adjustment required by this equity consideration.

In addition to the averaging objective in preferential treatment of long-term capital gains, a low rate of tax is often deemed necessary to encourage prompter realization of these gains. The desire to avoid income tax strengthens the natural tendency to hold on to investments. If existing provisions for capital gains taxation have the effect of unduly retarding realization, this may be due as much to defects in the capital gains tax structure, for example, to the fact that capital gains may be transferred free of income tax at death, as to the mere existence of the tax.

The holder of an appreciated capital asset who would like to switch to some other investment must find an alternative that he considers sufficiently preferable to his present holding to offset the tax and other costs (brokerage, etc.) of the exchange. The tax cost is dependent on the rates of capital gains taxation; these in turn vary with the amount of accumulated gain and with the size of the taxpayer's ordinary income. Any significant tax on capital gains levied at the time of realization will undoubtedly tend somewhat to discourage sales of appreciated property. The higher the tax rate, the stronger this effect will be. However, the tax factor is only one among a number of considerations influencing investment decisions. It may be much less important to a given investor than his forecast of future price and other economic trends.

The question of the proper levels of preferential rates to apply to long-term gains is complicated by the conflicting considerations involved. In general and

unless capital gains are very large relative to ordinary income, only moderately preferential rates are usually needed for the majority of long-term capital gains in order to make appropriately equitable adjustments for the greater lumpiness and more sporadic nature of these gains compared with ordinary income. On the other hand, if minimum interference with markets for capital assets rather than tax equity is the standard, a relatively low set of tax rates for long-term capital gains may be indicated. If maximum revenue from capital gains taxation is the standard, an intermediate schedule of rates, which does not too greatly restrict transactions and at the same time does not encourage an excessive amount of conversion of ordinary income into preferentially taxed long-term capital gains, may be desirable. Moreover, intermediate rates may be held to effect a reasonable compromise between the conflicting equity and market considerations.

Finally, any generally acceptable solution of the capital-gains tax problem might require complex tax provisions. It is important for administration and compliance that these complications be kept to a minimum. In the past, Congress has sought as much simplicity as was consistent with prevailing views concerning the objectives of capital-gains taxation. . .

Preferential treatment of capital gains has been justified on several grounds, namely, equity, incentive, and revenue yield.

With respect to equity, it has been pointed out that it is unfair to include with other income and to tax at progressive rates in the year of realization capital gains which have accrued over a number of previous years. It has become more or less generally accepted that an equitable principle of taxation for capital appreciation under an annual income tax would be one under which the tax on capital gains levied upon realization would approximate that which would have been paid if the gain or loss, treated as ordinary income or loss, had been realized as it accrued annually.

One of the earliest proposals for special treatment of capital gains which received the serious consideration of Congress provided for prorating realized capital gains, together with certain other types of income, over the years during which the capital asset had been held or the other income earned. This method was rejected, however, as too complicated for administration.

Consideration has also been given at various times to such proposals as (1) the inclusion in taxable income of annually accrued though unrealized gains and losses, and (2) proration or averaging of realized capital gains, either separately or with other income, over several years—not necessarily the number of years the capital assets have been held. These methods were likewise rejected largely because of administrative and compliance complexities, but also in part because of constitutional questions and fear of causing taxpayer hardship.

Throughout the history of capital-gains taxation, continuous concern about the effects of the tax on (*a*) sales and exchanges, (*b*) security and other property prices, and (*c*) revenue yield has been apparent. It was the belief that a moderate tax rate would encourage the sale of much appreciated property which otherwise would not be sold that provided the main foundation of the case for the introduction of preferential treatment in 1921.

Congress has tried time and again to find a method, both practicable and equitable, of taxing capital gains. Such a method has been conceived to be one which

would interfere as little as possible with realization of gains and at the same time would not stimulate loss realization too much.

But finding satisfactory formulas for achieving the divergent equity and incentive objectives that are entwined in the philosophy of capital-gains taxation and at the same time protecting the revenue has been a difficult problem. Consequently, the history of the legal provisions has been a record of compromise and change without satisfactory solution.

NEW YORK STOCK EXCHANGE
TAXES—EQUITY CAPITAL—AND OUR ECONOMIC CHALLENGES
(1953), pp. 38–40)

Tax treatment of capital gains and losses has changed from time to time in an effort to reconcile various unresolved conflicts between equity considerations, revenue requirements, and the desire to avoid reducing investment incentives and the marketability of capital assets.

Taxation of capital gains provides the federal government with only a small portion of its total tax revenue. (During the ten-year period 1942-1951, for example, 3 per cent of Federal income taxes paid by individuals represented receipts from capital gains.) The depressive effects of the present capital gains tax on investment incentives alone far outweigh, in their economic implications, the amount of revenue this tax provides.

Several special factors peculiar to capital gains taxation are pertinent to a precise understanding of its important economic implications

1. *Tax Liability is Matter of Choice.* To incur capital gains tax liability is a voluntary act undertaken at the discretion of the taxpayer. Therefore, even modest tax rates have the general effect of inducing many investors not to sell or exchange their capital holdings, which, in turn, means reduced tax revenue, restricted market activity, and impaired mobility in capital movement.

2. *Periodic Fluctuations in Security Values.* One of the fundamental characteristics of a free securities market is its sensitivity to the diverse factors which influence investors' evaluations of their future interest and future price movements. Changes in the economic climate, both in this country and abroad, changes in our political or economic relations with other countries, new discoveries, sudden increases in product popularity, and many other factors, can substantially affect security prices in a period as brief as a few days or as long as several months. Many instances of this sensitivity are observable in the price movements of individual and industry-wide stock issues, even when overall market averages are steady. But today's capital gains tax law (with a six-month holding period) unfortunately prevents many security transactions of a non-speculative nature which would otherwise be made if the holding period were less than six months.

In a study of public stock transactions made by the New York Stock Exchange, it was found that 806,000 shares were sold at a gain by "public" individuals (that is, persons other than members or allied partners of the New York Stock Exchange), on the two days surveyed. The following percentages of the shares sold

had been held for the indicated periods of time: under 30 days, 3 per cent; 30 days to 6 months, 20 per cent; 6 months to one year, 26 per cent; over one year, 48 per cent; no indication, 3 per cent. From these data it seems fair to conclude that a substantial number of the delayed transactions—certainly a large part of the 26 per cent held for 6 months to one year—were deferred for the express purpose of meeting the holding period provisions of the capital gains tax law.

It was not the intent of Congress when it set up the holding period that it should act as a barrier against sound investment transactions. It was rather an arbitrary device designed to help distinguish between capital gains deserving special tax treatment and gains which are so close to being ordinary income that they should be taxed as such. As such, however, the six-month holding period is too long, and has proven unnecessarily restrictive. A period of three months would be a more desirable dividing line because:

1. It would differentiate as well as the present six months period between those capital transactions deserving of special treatment and those which should be taxed as ordinary income.
2. It would be as workable administratively.
3. By permitting the freer exercise of investment judgment, it would result in thousands of additional transactions in capital assets, and result in substantial additional government revenues.
4. It would increase the liquidity of the securities markets, thus providing needed encouragement to equity investment.

3. *Price Level Changes and "Locked-In" Capital.* The substantial increase in the general price level in the last two decades has resulted in much capital appreciation.* Because of this general increase in price levels the proceeds of the realization of such gains are largely "illusory" in terms of real value. Nevertheless any realized gains, whether real or not, are subject to tax liability. But, since the tax is self-imposed, an investor who regards his gains as fictitious can avoid it by not shifting his investment. The result is a "freezing" or "locking-in" of large sums of capital which otherwise could be of more productive use if put into newer, or different industries.

4. *Taxing Transfers of Permanently-Invested Equity Capital.* An established principle of tax policy has been to permit the tax-free transfer of certain assets similar in kind, such as farms, real estate, livestock, etc.† The tax laws, in the Revenue Act of 1950, extended this principle by permitting the tax-free shifting of personal residences.‡

The above principle of taxation would be even more valuable to the national economy if it were applied to equity funds as long as they remained invested in productive enterprise. It would eliminate a major cause of investment-fund stagnation since, at present, the transfer of investments are undertaken, in a great many cases, only when the asset purchased yields a substantially higher return than did the one being liquidated.

5. *"Roll-Over" Proposal.* One suggestion, which has been considered from time-to-time, would apply this principle of tax-free transfers of assets similar in value and in kind to all forms of capital reinvestment. This suggestion, sometimes

* See Cloe, "Capital Gains and the Changing Price Level," 5 *Nat'l Tax J.* 207 (1952). [Ed.]
† Sec. 1031. [Ed.]
‡ Sec. 1034. [Ed.]

termed the "roll-over" proposal, would have the effect of deferring the capital gains tax until *final* "realization" of the capital asset. Thus, for example, an investor would *not* be taxed if he sold one security for the purpose of purchasing another within a given period of time, or sold a farm, timberland, etc., for similar reinvestment of the proceeds.

A tax liability would be incurred only on that portion of capital *not* reinvested in productive enterprise, or *not* reinvested in similar types of capital assets.

Although this proposal would provide more equitable treatment for certain types of capital transactions, it would not be a complete solution and would also involve tremendous administrative complexities. The more practical immediate solution would appear to be a substantial lowering of the rate and a shortening of the holding period to permit such transfers to be made without today's excessive tax impact.

6. *Inflationary Effect of Capital Gains Tax on Security Prices.* The effect of the present capital gains tax in keeping large quantities of stock off the market can be an additional inflationary factor of considerable significance in a period of high or rising prices. Moreover, the impact of the tax under such conditions becomes even greater as prices continue to rise—which is when, in the interest of price stability, stockholders should be encouraged to liquidate holdings rather than retain them.

SIMONS
FEDERAL TAX REFORM

University of Chicago Press (1950), pp. 70–71
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The capital-gains problem has now three important aspects. First, accrued gains on property held until one's death are never reached as taxable income at all. Second, gains realized by sale are only partially taxable and, besides, are subject to a maximum rate far lower than the maximum rate on other income. Third, deductions for capital losses are limited and segregated, so that, while those who have net capital gains are grossly undertaxed, those who have net capital losses are often grossly overtaxed. Limited deduction for losses is actually inseparable politically from limited inclusion of gains; but to regard the two limitations as offsetting is to repudiate the primary purpose of income taxation, namely, fairness among persons. It is indeed a shabby apology for present practice that, if it obviously undertaxes some persons, it obviously overtaxes others.

Even if one overlooks the major flaw, namely, failure to reach gains on property transferred by gift or at death, the limited taxation of realized capital gains is obviously inconsistent with our whole scheme of progression. *It is inherently unjust to impose any bracket rate in excess of the maximum rate applicable to capital gains.* In the long view, we must either abandon progression or abandon special treatment of capital gains and losses. This should be too obvious for argument, now that even the huge salaries and bonuses of corporation executives are often converted into a capital-gain form, by the device of the option to purchase the corporation's stock. The logical conclusion of recent trends in legislation is a blanket option for every taxpayer to treat any income as capital gain, if and as

he so desires. This option would give us an effective maximum rate about equal to the minimum or basic rate; and Congress could then manipulate the rest of the surtax scale as it pleased and without any effect on anybody! But the scheme would have the great merit of imposing similar taxes on people in similar circumstances.

Note

The student will note that so far we have not tried to define the phrase "capital gains and losses." The authors who have been quoted have obviously meant primarily gains and losses on the sale of corporate securities. But do they mean to include only the casual investor or would they grant the same special treatment to the transactions of one who makes his entire living by "playing the market?" Would they include even the dealer who maintains a regular office, with a large clientele, for the purchase and sale of securities? What other kinds of property should get special treatment? Real estate? Used machinery and equipment? Patents? Contract rights? Merchants' inventories? Should the special treatment be restricted to property that has been *sold*? What if the property has been stolen or destroyed?

These questions, and a host of others like them, must be answered, once it has been decided to grant special treatment to "capital" gains and losses. Occasionally the statute answers the question clearly, but more frequently the lawyer must be called in. The cases that follow focus on the statute, of course, but the student should also ask himself in each case whether the income or loss ought to be treated specially.

See generally Miller, "The 'Capital Asset' Concept: A Critique of Capital Gains Taxation: I and II," 59 *Yale L.J.* 837, 1057 (1950); Lowndes, "The Taxation of Capital Gains and Losses Under the Federal Income Tax," 26 *Tex. L. Rev.* 440 (1948); Tax Institute, *Capital Gains Taxation* (1946), and, for a view into the future, Blum, "The Decline and Fall of Capital Gains. 1921–1957," 28 *Taxes* 838 (1950).

Section B. Securities

1. *Are They Capital Assets?*

Note: Section 1221 of the 1954 Code, defining the term "capital asset," reenacts § 117(a)(1) of the 1939 Code, except that paragraph (4) of § 1221 is new.

See Regs. 118, Sec. 39.117(a)-1.

VAN SUETENDAEL v. COMMISSIONER

Tax Court of the U. S., 1944

¶ 44,305 P-H Memo TC

MEMORANDUM FINDINGS OF FACT AND OPINION

HARRON, Judge: ...

During the taxable years, and for some years prior thereto, the petitioner was primarily engaged in buying and selling securities. Approximately 90 per cent of the securities purchased by him were interest-bearing bonds and the other 10 per cent consisted of preferred and common stock. His income was derived

principally from interest on the bonds purchased and from interest on bank deposits. He maintained an office in Yonkers and had one employee who acted as his secretary-typist and general assistant. He was not a member of any stock exchange. His name was listed in several statistical financial publications as a dealer in securities, and in the Yonkers city and telephone directories under the classification of "investments." He also listed offerings to buy or sell securities at a certain price in the National Daily Quotation Service, for which he paid an annual subscription fee. This service was circularized among investment and trading houses in the United States. Petitioner has registered with the Securities and Exchange Commission, the State of New York, and the Bureau of Internal Revenue as a broker or dealer in securities. From time to time he has advertised in a Yonkers newspaper offering to buy or sell certain securities. Occasionally, his name appeared in the advertising section of the Columbia Alumni News under the caption "Investment Securities." He has also written to individuals, banks, and insurance companies offering securities at stated prices. Over a period of years, he has occasionally distributed calendars and pocket manuals containing data on securities of companies listed on the leading stock exchanges. Prior to the taxable years, petitioner, to a small degree, had participated in selling groups for the purpose of distributing new issues of securities....

During the taxable years, petitioner maintained separate accounts with Eastman, Dillon & Company, Ira Haupt & Company, and Chisholm & Chapman, all of whom were brokers, having membership on the New York Stock Exchange and the New York Curb Exchange. The great proportion of the securities sold by the petitioner during these years were sold to or through Eastman, Dillion & Company and Ira Haupt & Company. Excluding sales to petitioner's wife and son, approximately 77 per cent of petitioner's total sales in these years were made to or through Eastman, Dillon & Company and Ira Haupt & Company. Some of the securities purchased by petitioner from these brokers were kept by them for petitioner. Many of the specific securities sold to or through Eastman, Dillon & Company and Ira Haupt & Company had been previously purchased by petitioner from these same brokers....

In reporting the transactions of the sales of securities in each year on his return, petitioner took the view that all of the securities sold were non-capital assets, so that he computed the result of all the transactions in each year simply by taking the total cost of the securities and the total receipts from sales....

The respondent, in determining the deficiencies, held that the securities sold by petitioner were capital assets, and he therefore applied the limitations of section 117 [§ 1211(b), 1954 Code] in computing petitioner's net income from the sale of such securities.

Opinion

In this proceeding, as well as in a former proceeding before the Board of Tax Appeals involving prior taxable years, the petitioner has attempted to show that he was recognized in the security trade as a dealer in securities. He has placed great emphasis on the fact that he had registered with the Securities and Exchange Commission and the State of New York as a security dealer. Similarly, he has pointed to advertisements placed by him in newspapers, bulletins, and pamphlets indicating

that he dealt in securities during the taxable years. On brief, he argues that the entire case resolves itself to the one question of whether he was engaged in business as a dealer in securities. That, however, is not the issue. The phrase "dealer in securities" is not defined in the statute, although it is defined in the Regulations. Regulations 118, Sec. 39.22(c)-5. The only issue for determination here is whether the securities sold by petitioner during the taxable years were capital assets under section 117(b) of the Revenue Act of 1936 and section 117(a)(1) of the Revenue Act of 1938. For the purpose of this proceeding both sections of the Acts are substantially identical.

Under the cited sections of the Revenue Acts, all property is to be treated as capital assets unless the taxpayer is able to bring himself within one of the stated exceptions in the definition of capital assets. As far as this proceeding is concerned, the only possible exceptions which petitioner could rely upon are that the securities sold were

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The securities which petitioner sold during the taxable years cannot be classified as stock in trade or property subject to inventory in his hands unless they were held by him primarily for sale to customers in the ordinary course of his business. Thus, the issue turns on whether or not the securities sold by petitioner during the taxable years were held by him primarily for sale to customers in the ordinary course of business. This is probably the reason why petitioner has placed such stress upon the contention that he was a dealer in securities since securities in the nature of stock in trade held primarily for sale to customers are held only by dealers in securities. See Francis Shelton Farr, 44 B.T.A. 683. However, there may be many sales of securities by so-called dealers in securities which do not come within the exceptions set forth in the definition of capital assets. The fact that petitioner had a teletype machine, four telephones and statistical financial publications in his office, was listed as a "dealer" in certain publications, and advertised himself as willing to buy or sell securities is not determinative of the issue. The subject matter of the cited sections is property and it must be shown that the property itself comes within the exceptions stated in the definition of capital assets.

The respondent has determined that the securities sold by the petitioner during the taxable years were not held by him primarily for sale to customers in the ordinary course of his business. The burden of proving otherwise is upon petitioner The question is predominantly one of fact. . . .

From an analysis of the schedule showing all of petitioner's transactions in securities during these years, we cannot find as a fact that petitioner held the securities sold by him during the taxable years primarily for sale to customers in the ordinary course of his business. The facts are just as consonant with the theory that petitioner held the securities for speculation or for investment. It is well established that taxpayers who buy securities for speculation or investment hold them as capital assets and not primarily for resale to customers. *Seeley* v. *Helvering*, 77 F.(2d) 323, 15 AFTR 1402; *O. L. Burnett*, 40 BTA 605, affirmed on point considered here, 118 F.(2d) 659, 26 AFTR 893; *Vaughan* v. *Commissioner*, 85 F.(2d)

497, 18 AFTR 455, certiorari denied, 299 U.S. 606. One who holds securities in the nature of stock in trade primarily for resale to customers is regularly engaged in the purchase of securities at wholesale. *Francis Shelton Farr, supra.* He is a middleman in distributing the securities and he does not resell to the same class of persons from whom he buys. *Seeley* v. *Helvering, supra.* Here, petitioner did not make wholesale purchases of securities. The securities purchased were in relatively small quantities and were diversified. In this respect, he acted no differently from an ordinary purchaser. Most of the securities purchased by petitioner were resold to or through the same brokers from whom they were bought. Here again, petitioner acted in the same manner as an ordinary purchaser having an account with a broker. Approximately 77 per cent of all the securities sold by petitioner during the taxable years, excluding those sold to his wife and son, were sold to or through Eastman, Dillon & Company and Ira Haupt & Company. In most of these transactions, the companies acted as brokers and did not purchase the securities as principals for their own account. These brokers or their clients cannot be considered as petitioner's customers. *Francis Shelton Farr, supra*; *Seeley* v. *Helvering, supra*; *Vaughan* v. *Commissioner, supra.* Over 92 per cent of the securities sold by petitioner to or through Eastman, Dillon & Company and Ira Haupt & Company had been previously acquired by him from the same two brokerage houses. Many of these securities were resold by petitioner at a profit on the same day in which he purchased them or a short time thereafter. Obviously, in those cases, he never actually received the securities since the brokers who purchased and sold them for him were the same. The result of those transactions was that petitioner merely received or was credited with the profit. In this respect, his operations were similar to a trader purchasing securities on margin. Petitioner could not have intended to purchase these securities for resale to "customers" as that word is used in the statute. Some of the securities purchased through the two brokerage houses were not delivered to petitioner, but were kept by the brokers. It may be that they were retained as collateral for loans, which would be another indication that petitioner was purchasing and holding the securities for speculation. Our analysis of these schedules, together with the record as a whole, warrants the conclusion that the securities purchased by petitioner were not held as stock in trade primarily for resale to customers. Although petitioner did make efforts to sell some of the securities through channels other than brokers and dealers, and actually did sell a small amount of the securities to other parties, we cannot find even as to those securities that they were purchased primarily for resale to customers. A mere statement in behalf of petitioner that they were purchased or held for that purpose is insufficient. *Vaughan* v. *Commissioner, supra.* We think that the purchases and sales of all of the securities were engendered by the speculative advantage which might be derived by petitioner, or the income which he might receive therefrom.

Respondent points out that during the taxable years, petitioner's principal source of income was derived from interest on the bonds owned by him and that the great proportion of his losses resulted from securities which he had held for a long period of time. He argues that petitioner, during each of the taxable years, selected securities which he had held for a long time and which were then unprofitable to him and disposed of those securities at the best possible price to anyone who would buy them in order that the loss sustained thereon should offset his in-

come from the interest-bearing bonds held by him. The facts indicate that petitioner received interest on bonds in 1936 in the amount of $25,012; in 1937 in the amount of $27,120.23; and in 1938 in the amount of $31,683.25. During the same period, petitioner reported on his income tax returns, business losses in substantially the same amounts. The facts also show that in 1936, of the total losses of $35,796.68 sustained by petitioner from the sale of securities, $32,659.67 was sustained on securities held by him for more than five years. In 1937, of the total losses of $37,660.91 sustained by petitioner, $16,096.34 was sustained from securities held more than five years. In 1938, of the total losses of $25,806.13 sustained by petitioner, the amount of $21,441.41 was a long-term loss sustained on securities held for more than 18 months. Respondent also argues that as to the securities held for a long period, petitioner did not hold them for resale to customers, but for the income which he might derive therefrom. The facts apparently support respondent's contentions. Respondent also states in his brief that in all of the years since 1929, petitioner has reported substantial income from interest and dividends, yet, in all of these years, his sales of securities have resulted in substantial annual losses which were offset against his income. There appears to be ground for this statement. See *Achille O. Van Suetendael,* ¶ 40,269 P-H Memo BTA.

Petitioner has placed considerable reliance upon *United States* v. *Chinook Investment Co.,* 136 F.(2d) 984 (9th Cir. 1943). The facts of that case, however, are not shown in the opinion and the court merely affirmed the decision of the district court, which had found that the securities sold were held by the taxpayer for resale to customers in the ordinary course of business. The facts in the district court decision are not reported. *Chinook Investment Co.* v. *United States,* 30 AFTR 1618.

A careful study of the whole record, including all of the exhibits in evidence, convinces us that petitioner has not sustained the burden of proof imposed upon him of showing that the securities sold during the taxable years were held by him primarily for sale to customers in the ordinary course of his business. The proof is just as susceptible of a construction that some of the securities were acquired and held by petitioner for speculation and some for investment. We think that a reasonable conclusion from all of the facts is that petitioner intended to sell the securities in any way he could and to any purchaser regardless of whether or not the purchaser could be deemed a "customer" within the meaning of the statute. It is therefore held that the securities sold by petitioner during the taxable years were capital assets and subject to the limitations of gain and loss set forth in sections 117 of the Revenue Acts of 1936 and 1938. Respondent's determination is sustained.

Note

1. The Tax Court's decision was affirmed per curiam, *Van Suetendael* v. *Commissioner,* 152 F.2d 654 (2d Cir. 1945):

> This issue was predominantly one of fact and the Tax Court's finding was adverse to the taxpayer. We cannot say that "the Tax Court's inferences and conclusions on this factual matter are so unreasonable from an evidentiary standpoint as to require a reversal of its judgment." . . . With respect to some of the securities sold the taxpayer may have been a dealer and with respect to others a trader, investor or speculator. In his returns he made no attempt to distinguish one sale from another; nor did he present sufficient evidence to enable the Tax Court to do so.

In *Commissioner* v. *Burnett*, 118 F.2d 659 (5th Cir. 1941), a leading case in this area, it was held that a "trader" in securities and commodities, whose trading averaged over $10,000,000 per year, did not hold property "primarily for sale to customers in the ordinary course of his trade or business." 152 F.2d 654–655.

Should a "trader" in securities be treated differently from a dealer, either when he has gains or when he suffers losses? The requirement that property, to avoid capital asset treatment, be held for sale "to customers" came into the statute in 1934. It was designed to prevent "a stock speculator trading on his own account" from claiming ordinary losses on his transactions and thus cancelling out his income from dividends, interest, *etc.* by what were apparently thought by Congress to be frequently fictitious transactions. H.R. Rept. No. 1385, 73d Cong. 2d Sess., 39-1 C.B. (Part 2) 627, 632. In enacting the restriction, Congress seems to have overlooked the possibility that, in another part of the business cycle, "traders" might realize profits and would be able to report them as capital gains. In point of fact, the 1934 amendment ultimately proved to be superfluous; in *Higgins* v. *Smith*, *supra*, p. 196, decided in 1941, the Supreme Court held that a trader was not engaged in a "trade or business" under § 162(a). Presumably he was also not engaged in a "trade or business" as the term is used in § 1221, so that even without the phrase "to customers" his losses would be capital rather than ordinary.

2. A dealer in securities may hold some of his securities in an "investment account" rather than for sale and thus qualify them as capital assets. *Carl Marks & Co.* v. *Commissioner*, 12 T.C. 1196 (1949). Section 1236, added to the Revenue Act of 1951, requires such investment securities to be clearly identified as such, to prevent the taxpayer from claiming capital asset treatment if they are sold at a profit, but non-capital treatment if a loss is incurred. By virtue of § 1236(b), once a security has been identified as held for investment, any loss on a subsequent sale or exchange by the dealer will be a capital loss; the security cannot be effectively transferred to the category of property held for sale to customers.

3. As will be seen, some types of property, though non-capital, receive capital gain or loss treatment in special circumstances. Property that falls under § 1221(1), however, is never so treated; it always gives rise to ordinary income or loss.

In a few cases, losses on the sale of securities, though seemingly "capital assets" under § 1221, have been treated as business expenses under § 162(a) rather than as capital losses on the theory that taxpayer bought the securities not for investment, but as an incident to its regular business. For example, in *Bagley & Sewall Co.* v. *Commissioner*, 20 T.C. 983 (1953), the taxpayer purchased certain government bonds for deposit in escrow to insure its performance of a contract. When the bonds were released from the escrow, it sold them at a loss. The loss was held to be deductible under § 162(a). See also *Western Wine & Liquor Company* v. *Commissioner*, 18 T.C. 1090, *Pressed Steel Car Company* v. *Commissioner*, 20 T.C. 198 (1953). For a contrary holding on similar facts, see *Exposition Souvenir Corporation* v. *Commissioner*, 163 F 2d 283 (2d Cir. 1947). If the bonds had been sold at a profit, would it be taxed as ordinary income rather than as capital gain?

2. *Was the Asset Sold or Exchanged?*

> ***Note:*** **Sections 1222, 1232(a)(1), and 165(g) of the 1954 Code, relating to sales, exchanges, and similar transactions, are based upon §§ 117(a)(2)-(11), 117(f), 23(g), and 23(k)(2)-(5) of the 1939 Code, but some changes have been made.**
> **See Regs. 118, Secs. 39.23(g)-1 and 39.23(k)-1.**

To qualify for capital gain or loss treatment, the transaction not only must involve a capital asset but also it must constitute a "sale or exchange." This phrase is narrower than § 1001(a)'s phrase "sale or other disposition." Thus, in *Herbert's Estate* v. *Commissioner*, 139 F.2d 756 (3d Cir. 1943), it was held that when a claim was paid by the debtor, it was "disposed of" by the creditor so as to bring § 1001

(a) into play. The claim was held by the estate of the lender, and under § 1014, its basis to the executors was its value at the date of death. The executors had collected more than this amount, and the government contended that the excess was "gain from the sale or other disposition of property," under § 1001(a). The court agreed, and added that in the alternative the excess might be taxable under § 61(a). Although the creditor is held to have made a "disposition" of the claim in these circumstances, he has not "sold or exchanged" it so as to warrant capital gain or loss treatment. *Hale* v. *Helvering*, 85 F.2d 819 (D.C. Cir. 1936); *Fairbanks* v. *United States*, 306 U.S. 436 (1939); see also *Fahey* v. *Commissioner*, 16 T.C. 105 (1951) (compromise settlement of claim not a "sale or exchange"); *Hudson* v. *Commissioner*, 20 T.C. 734 (1953) (settlement of judgment not a "sale or exchange").

There are certain statutory exceptions to § 1222's general requirement of a "sale or exchange." Thus, § 1232 provides that in general a retirement of certain securities shall be treated as a sale or exchange. The reason, no doubt, is that capital gain or loss would result if the security were sold just before maturity (unless the sale could be ignored as a sham), and there is no reason to differentiate a retirement. See also Section 165(g), which for a similar reason provides that worthless securities shall be treated as though they had been sold or exchanged in the year they became worthless. Sections 1232 and 165(g) are applicable only to *corporate* securities. Thus, if a bond issued by an individual is *retired* at above its basis, the holder will have ordinary income (since the bond, though a capital asset, has not been sold or exchanged and § 1232 is inapplicable), but its *sale* at a profit will produce capital gain. A similar disparity may exist if a loss is incurred on a bond issued by an individual. If sold at a loss, the instrument will give rise to a capital loss; if held until worthless, it will produce an ordinary loss *unless* it is a "non-business debt" (see *Smith* v. *Commissioner*, *supra*, p. 257), in which event § 166(d) will require capital loss treatment.

Section 165(g) is applicable to bonds, notes, etc. with interest coupons or "in registered form." What does the latter phrase mean? See *Gerard* v. *Helvering*, 120 F.2d 235 (2d Cir. 1941); *Lynn* v. *Commissioner*, 15 T.C. 832 (1950) (dissenting opinion). Why should coupon-bearing or registered securities be treated differently from others? Can the taxpayer avoid the capital loss limitation of § 165(g) by de-registering the security (if it does not bear interest coupons) so that it is not "in registered form" when it becomes worthless? See *Lurie* v. *Commissioner*, 156 F.2d 436 (9th Cir. 1946). Note that the security may be a "non-business" bad debt, so as to be subject to § 166(d) even if it escapes § 165(g).

The predecessor of § 1232 (§ 117(f) of the 1939 Code) contained a similar requirement that the security be in registered form or bear interest coupons; see the *Lurie* case, *supra*. This requirement was eliminated by the 1954 Code for securities issued after 1954.

While Section 165(g) provides, as was stated above, that worthless securities shall be treated as sold or exchanged, these provisions are not ordinarily applicable to the securities of a subsidiary corporation. See Section 165(g)(3), whose purpose is to approximate roughly the treatment that would have been accorded to the loss if it had been incurred directly by the parent. Thus, if the subsidiary was engaged in manufacturing or selling, the parent's loss on its failure will be an ordinary loss, in recognition of the fact that if the operations had been carried

on by the parent without the intervention of the subsidiary, the parent would probably have deducted the expenses or losses of the operations from ordinary income. On the other hand, if the subsidiary was engaged in security speculations, the loss on its failure will be a capital loss, conforming to the tax effect that would have been felt if the parent had carried on such operations in its own right.

Section 165(g)(3) applies only if the securities of the subsidiary become worthless, not if they are sold.

3. Is the Gain or Loss Recognized?

We have already seen that sometimes gain or loss, though "realized" under § 1001, is not "recognized" under § 1002. See *supra*, p. 155, dealing with gain on the sale of the taxpayer's residence when another residence is acquired within one year.

Some of the most important—and intricate—provisions of the Code provide for the non-recognition of gain and/or loss on transactions involving securities. These "non-recognition" provisions, some of which will be examined in more detail later, are applicable to non-capital as well as capital assets, though ordinarily the securities involved are capital assets. Among these provisions are the following:

(a) Section 1036, which provides for the non-recognition of gain or loss in a transaction such as the exchange of Class A common stock for Class B common stock of the same corporation.

(b) Section 354(a)(1), which provides for the non-recognition of gain or loss on a corporate reorganization. An example is the exchange of stock in the ABC Corporation for stock of XYZ, Inc., when the former is merged into the latter. The stock received may be worth more or less than the adjusted basis of the stock given up, but neither gain nor loss is recognized. Non-recognition is dictated partly by the possibility that the taxpayers' investment has been changed only in form and not in substance, partly by the possibility that the taxpayer had no choice but to make the exchange, and partly by a desire to facilitate corporate adjustments to changing economic circumstance.

(c) Sections 371, 1071, and 1081, which provide for the non-recognition of gain or loss on certain exchanges of securities under judicial or administrative compulsion.

In addition to the non-recognition provisions, there are two other sections having a similar effect—though with respect to losses only—that should be referred to here:

(a) Section 1091, which disallows losses incurred on "wash" sales. Loss on the sale of stock or securities is not deductible if within 30 days before or after the sale the taxpayer acquires (or enters into a contract or option to acquire) "substantially identical stock or securities." The loss is disallowed regardless of the *bona fides* of the sale and even though the taxpayer may have no intent to acquire substantially identical stock or securities when the sale occurs. Only losses are subject to § 1091, the taxpayer will have to recognize any gain if he sells and promptly repurchases. This may be done deliberately; if, for example, the taxpayer has capital losses in a particular year, he may sell for a tax gain and rebuy so as to hold the securities at a higher basis. Section 1091 is applicable to stock and securities only. Loss on a sale of other types of property may be disallowed if the transaction is a sham (*e.g.*, accompanied by a secret agreement to reacquire), but there is no automatic non-recognition of the loss merely because of a prompt repurchase, as in the case of stock or securities.

(b) Section 267, which was considered in the *McWilliams* case, *supra*, p. 365. As was pointed out there, even where no specific statutory provision is applicable, sham sales do not give rise to deductible losses.

See Brodsky, "Losses and Wash Sales Between Related Taxpayers," 10th *Annual N.Y.U. Inst. on Fed. Taxation* 171 (1952).

Ordinarily, when the taxpayer's gain or loss on a sale or exchange is not recognized, the basis of the property acquired is so fixed that the taxpayer's entire economic gain or loss will be reflected when he disposes of that property.

Section C. Real Estate

1. *Is It a Capital Asset?*

Note: Section 1221(1) of the 1954 Code, relating to property held for sale, is a reenactment of § 117(a)(1)(A) of the 1939 Code.

Section 1221(2) of the 1954 Code, relating to real property used in trade or business, is a reenactment of § 117(a)(1)(B) of the 1939 Code.

Section 1237 of the 1954 Code, relating to real property subdivided for sale, is new.

MAULDIN v. COMMISSIONER

U. S. Court of Appeals, Tenth Circuit, 1952
195 F.2d 714

Before HUXMAN, MURRAH and PICKETT, Circuit Judges.

MURRAH, Circuit Judge.

This is an appeal from a decision of the Tax Court, holding that certain lots sold by petitioners during the taxable years 1944 and 1945, were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" within the exclusionary clause of Section 117(a)(1) of the Internal Revenue Code. If the gain from the sale of these lots was derived in this manner, it constituted ordinary income taxable under Section 22(a), and not a capital gain taxable under Section 117(a)(1). Petitioners, residents of the State of New Mexico, are husband and wife, and all income involved is community income. The two cases were therefore consolidated for trial and disposition. A summary of Mauldin's business activities is necessary to a determination of the issue presented.

C. E. Mauldin, a graduate veterinarian since 1904, who also engaged in some road contracting, moved to Albuquerque, New Mexico in 1916, where he organized a road construction company. While in Clovis, New Mexico in 1920, to bid on a sewer project, he decided to move there and engage in the cattle business. Later in the same year, he contracted to buy 160 acres of land one-half mile from the city limits of Clovis for $20,000.00. This land was particularly suitable for cattle feeding, but was not at that time considered suitable for residential development, because the City, with a population of 5000, was not growing in that direction.

By the time Mauldin finally received title to the land in June 1921, he decided that it was not the time to go into the cattle business because of drought, crop and bank failures, and a decline in the cattle business which continued through 1924. He tried to sell the entire tract in 1924 for less than he paid for

it, but was unable to do so, partly because a highway had been surveyed diagonally across the land, splitting it into two tracts and rendering it less suitable for cattle feeding. A real estate agent with whom he listed the property for sale advised him that they would have better success if he divided it into small tracts and blocks. The land was accordingly platted into 29 tracts and 4 blocks containing 88 lots each, and called the "Mauldin Addition." At the time the land was platted in 1924, there was still no demand for residential property in the area. In 1927, he built a home for himself near the center of the Addition.

There were no sales of any consequence until the land commenced to be included in the city limits of Clovis in 1931. By 1939, it was wholly within the city limits, and without Mauldin's request, the City began a paving program in the area, for which he was assessed approximately $25,000.00. When he was unable to pay this assessment, the City instituted suits on its paving liens, and in order to save his property, he divided some additional tracts into lots and devoted most of his time to the sale of the lots in the Addition. He listed the property with real estate agents and otherwise promoted sales through personal solicitations, signs, newspaper advertisements, and gifts of lots to a school and the builder of the first F. H. A. house in Clovis. He stated that at times he would "chase" a prospective purchaser "around the block." During 1939 and 1940, he sold enough lots to liquidate the paving indebtedness.

Mauldin testified that with the indebtedness to the City paid, he decided to hold the remaining portions of the original tract for investment purposes, and after 1940, did nothing to promote sales. He stated, "I cut it up and tried my best to sell it to clear it, and when I cleared it, I quit." From 1940 until 1949, when his health failed, Mauldin devoted full time to the lumber business he organized in 1939. During this period, he had no real estate office, no license to sell real estate, did not advertise the properties by newspapers or signs, had no fixed price for lots, and at times refused to sell certain lots, either because the prospective purchaser would not pay the asked price, or Mauldin did not wish to sell the particular property at that time. The only real estate purchased by Mauldin after acquiring the 160 acres in 1920 was one "unsightly" block of lots near his residence, and some commercial properties to be used in connection with his lumber business.

Due primarily to the location of war facilities nearby, the City of Clovis grew in population to 14,000 in 1940 and to 20,000 to 25,000 in 1945, and the lots in Mauldin Addition were in great demand. By the end of 1945, Mauldin had disposed of all but 20 acres of his original 160 acre tract. This 20 acres was considered by him and real estate dealers to be his most valuable property. Mauldin's records show that he sold 2 lots in 2 transactions in 1941; 11 in 1942 in 2 transactions (6 lots were given to his daughter as a wedding present); 5½ in 1943 in 3 transactions; 5½ in 1944 in 3 transactions, 44½ in 1945 in 15 transactions; 39 in 1946, 1 in 1947 and 2 in 1948. For the taxable years in 1939 and 1940, the taxpayers' income tax returns showed income from real estate only; for each of the years 1941 and 1944 (returns for 1942 and 1943 not shown) they showed net income of approximately $3,000.00 from sales of real estate and approximately $12,000.00 from the lumber business; for the year 1945, $20,484.84 from real estate and $12,339.80 from lumber; and in 1946, $21,942.88 from real estate and $25,005.07 from lumber. On his 1940 return, Mauldin stated

that the nature of his business was "real estate"; in 1943 it was shown as "lumber business"; in 1944 he did not designate the nature of his business; and in 1945 it was shown as "lumber and real estate."

In their income tax returns for the years 1944 and 1945, petitioners showed the lots sold during those years as long-time capital assets, and computed the tax accordingly. The Commissioner determined that the profit realized was ordinary income within the meaning of Section 117(a) (1) of the Internal Revenue Code, and assessed the additional tax. This appeal is from the judgment of the Tax Court sustaining the Commissioner, and the only question is whether its judgment on these facts can be said to be clearly erroneous.

It is admitted by taxpayer that during 1939 and 1940, he was engaged in the business of selling the tracts and lots in Mauldin Addition. He earnestly contends, however, that after 1940, his business status was changed; that his full time thereafter was devoted to the lumber business, and held the remaining lots for investment purposes, selling them only through unsolicited offers when the price was right.

There is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must, in the last analysis, rest upon its own facts. There are a number of helpful factors, however, to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and continuity and frequency of sales as opposed to isolated transactions. *Dunlap* v. *Oldham Lumber Co.*, 5 Cir., 178 F.2d 781; Annot. 106 A.L.R. 254; *Mertens*, Vol. 3, Sec. 22.08. And, any other facts tending to indicate that the sales or transactions are in furtherance of an occupation of the taxpayer, recognizing however that one actively engaged in the business of real estate may discontinue such business and simply sell off the remnants of his holdings without further engaging in the business. *Snell* v. *Commissioner*, 5 Cir., 97 F.2d 891. Thus, where residents of New York bought land in Florida and elsewhere from time to time for investment, a part of which was platted and improved, it was held that the occasional sale of lots through local brokers was not sufficiently frequent or engrossing to give the taxpayers the vocation of real estate dealers. *Phipps* v. *Commissioner*, 2 Cir., 54 F.2d 469. And, in *Foran* v. *Commissioner*, 5 Cir., 165 F.2d 705, a taxpayer admittedly engaged as a broker of nonproducing oil and gas leases and royalties purchased a producing property which he sold within eighteen months. The profit realized therefrom was held to be income from a long-time capital asset, the court reasoning that since this was the first producing property purchased by the taxpayer, there was no occasion to disbelieve his statement that he acquired it for investment or his motive for selling it.

On the other hand, sale and exchange of lots in 1939 and 1940 from a 92 acre tract of land, partially subdivided in 1932, was held to be in the ordinary course of business where the taxpayer had been continuously engaged in the real estate business since 1908, and had divided a part of the tract into lots in order to facilitate the sale of the land. *Gruver* v. *Commissioner*, 4 Cir., 142 F.2d 363. So too was the sale of lots from a tract of land which had been originally purchased for and used as a lettuce farm, but subdivided into lots when it became too valuable for truck farming operations. *Richards* v. *Commissioner*, 9 Cir., 81 F.2d 369,

106 A.L.R. 249. See also *Oliver* v. *Commissioner*, 4 Cir., 138 F.2d 910. And, lots sold through sales agencies after reacquisition at a trustee's sale, were held to be in the ordinary course of trade or business, as against the contention that they were sold in furtherance of an orderly liquidation in *Ehrman* v. *Commissioner*, 9 Cir., 120 F.2d 607. While the purpose for which the property was acquired is of some weight, the ultimate question is the purpose for which it was held. *Rollingwood Corp.* v. *Commissioner*, 9 Cir., 190 F.2d 263.

Admittedly, Mauldin originally purchased the property for purposes other than for sale in the ordinary course of trade or business. When, however, he subdivided and offered it for sale, he was undoubtedly engaged in the vocation of selling lots from this tract of land at least until 1940. As against his contention that he ceased to engage in the business after 1940, the record evidence shows that he sold more lots in 1945 on a sellers market without solicitation than he did in 1940 on a buyers market. It seems fairly inferable from the record that at all times he had lots for sale, and that the volume sold depended primarily upon the prevailing economic conditions, brought on by wartime activities and their aftermath. It is true that he was in the lumber business, but his returns plainly show that a substantial part of his income was derived from the sale of the lots. In these circumstances, we cannot say that the Tax Court's conclusions are without factual basis.

The decisions are Affirmed.

Note

1. Compare this taxpayer with Mr. Van Suetendael, in *Van Suetendael* v. *Commissioner*, *supra*, p. 390, whose securities were held to be capital assets. Is there any reason of policy why one should realize ordinary income and losses on his transactions while the other has capital gains and losses? If the persons to whom Mr. Mauldin sold his land were "customers," as that term is used in § 1221(1), why were not the persons who bought securities from Mr. Van Suetendael also "customers"? Neither taxpayer had a "clientele" of the kind that a department store or other dealer in merchandise has. In *Black* v. *Commissioner*, 45 B.T.A. 204 (1941), it was stated that for a taxpayer regularly engaged in the business of buying and selling real estate, "any person who can be found to buy such property is a customer." This seems to mean that as respects real estate, the term "to customers" adds nothing to the statutory requirement that the property be held "primarily for sale . . . in the ordinary course of his trade or business." It has already been pointed out, *supra*, p. 395, that the phrase "to customers" turned out to be an unnecessary precaution in the case of traders or speculators in stock.

See also *Hollis* v. *United States*, 121 F. Supp. 191 (N.D. Ohio 1954), on the meaning of "customers."

2. See § 1237, added in 1954. What is the significance of its basic principle that certain lots "shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale *solely* because of the taxpayer having subdivided" the tract, *etc.* If there are other factors pointing to a trade or business, is § 1237 inapplicable? May the fact of subdividing a tract be regarded as a persuasive factor, even though it is not the *sole* reason for denying capital gain or loss treatment? Does § 1237(b)(1) mean that ordinary income must be reported, even though but for this provision, the property would give rise to capital gain? Does it mean that ordinary income will be realized on the sale of property held for five years or more (see § 1237 (a)(3)) but that property held for a shorter period, unless otherwise shown to be held for sale, will produce capital gain? Section 1237 applies only to noncorporate taxpayers. Is it possible that a corporation will realize capital gain (*e.g.*, if land is held for investment, but more than five lots are sold) where an individual would realize ordinary gain, at least in part?

Can the effect of § 1237(b)(1) be minimized by splitting a tract up among all members of the family and arranging for them to sell alternate lots? If a parcel of land is divided among the members of the family, is it still one "tract" under § 1237(c)?

As the case indicates, it has not been easy to distinguish real estate held for sale from real estate held for investment. Fink, "'Dealing' in Real Estate," 2 *Tax L. Rev.* 111 (1946), cites many of the cases, and there have been many more since 1946, among others, see *Friend* v. *Commissioner*, 198 F.2d 285 (10th Cir. 1952).

3. Suppose Mr. Mauldin organized a corporation, transferred one of the lots to it in exchange for its stock, and then sold the stock His profit would be the difference between (a) his basis for the stock (which, as seen *infra*, Ch. 6, Sec. C, would be the same as the basis of the land transferred to the corporation) and (b) the sales price, which presumably would be about the same as the value of the land itself. Would this profit be capital gain? Section 341, which will be met again, *infra*, Ch. 6, Sec. F(1), expressly provides that the profit on certain transactions of this type is ordinary income, despite the fact that ordinarily the profit on a sale of stock is capital gain. Even without this elaborate statutory provision, the transfer of the real property to the corporation might be disregarded as a sham. What are the taxpayer's prospects for converting some of the lots into capital assets by giving them to members of his family? Bittker, "Charitable Gifts of Income and the Internal Revenue Code. Another View," 65 *Harv. L. Rev.* 1375, 1385–1388 (1952).

FACKLER v. COMMISSIONER

U. S. Court of Appeals, Sixth Circuit, 1943
133 F.2d 509

Before HICKS, ALLEN, and HAMILTON, Circuit Judges.

HAMILTON, Circuit Judge.

This is a proceeding to review a decision of the Board of Tax Appeals (now the United States Tax Court).

The Commissioner of Internal Revenue found a deficiency in petitioner's income tax for the calendar year 1938 in the sum of $4,639.67 which deficiency was sustained by the Board. The additional tax grows out of a profit realized from the sale of a leasehold.

On August 22, 1933, petitioner became lessee for a ninety-nine year lease, renewable forever, the lessor being the fee owner of certain lands with improvements thereon at 823 Prospect Avenue, in the business section of Cleveland, Ohio.

The property had on it a six-story building erected in 1916. The lease provided for the payment of an annual rental of $10,000 for the first five years of the term and $12,000 thereafter, for the ground and improvements. The lessee was to pay all real estate taxes, special or other assessments, water rents and other public charges already assessed or imposed upon the premises and unpaid and those thereafter assessed or imposed thereon during the term of the lease. The lessee was required also to keep the building on the premises in good repair and, in case of its destruction, to erect new improvements at a cost of not less than $200,000. In the event the lease was not renewed at the end of any term, all improvements on the property reverted to the lessor. The lessee was granted an option to purchase the property for the sum of $250,000 at the end of the lessor's life.

At the time petitioner acquired the property, all space in the building was occupied. When subsequent vacancies occurred, petitioner sought new tenants through his own efforts, and did not list the property with a real estate agency

but was willing to pay commissions to persons who obtained tenants for him. About 1936, petitioner closed all of the building except the ground floor, which, with the basement, was thereafter rented. In 1938, the rear of the first floor was occupied by the Western Union Telegraph Company and the remainder of the space was rented to tenants who operated a drug store, electrical store and haberdashery store. The basement was used by a tenant for the operation of a restaurant and barber shop. Two tenants moved out before April 1938 and the space used by them was thereafter vacant.

On September 30, 1938, petitioner sold the leasehold for $35,000 thereby realizing a net taxable gain of $29,064.32. The Board included this gain in petitioner's gross income under the provisions of Section 22(a) of the Internal Revenue Code. Petitioner contended before the Board, and now insists, that his gain was from the sale of a "capital asset" as defined in Section 117(a)(1) of the . . . . Internal Revenue Code.

The question turns on the interpretation of Section 117(a)(1) integrated with Section 23(*l*) of the Revenue Act of 1938, Internal Revenue Code § 23(*l*).

Section 117(a) (1) defines "capital asset" as property held by the taxpayer whether or not connected with his trade or business, but excludes property used "in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(*l*)."

Section 23(*l*) provides "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

Petitioner is a busy and successful lawyer and devotes all of his time to the practice of his profession. According to the findings of the Board, petitioner visited the leasehold premises once or twice each month, which consumed one or two hours of his time. . . .

The Board found that the lease in question was property of the taxpayer used in his trade or business and of a character subject to an allowance for depreciation, and therefore under the express terms of the statute that it was not a capital asset. This was the determination of an ultimate fact. We are limited therefore to an examination of the record to ascertain whether there is any substantial evidence to sustain the findings of the Board. *Helvering* v. *Rankin*, 295 U.S. 123, 133, 55 S. Ct. 732, 79 L. Ed. 1343. Petitioner sold neither lands nor buildings but a leasehold. The question subdivides into two branches, (1) Was the leasehold used by petitioner in a trade or business? (2) Was it of a character subject to an allowance for depreciation?

There is a trite definition of trade or business which is probably sufficient for the disposition of the question here. It is "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit." *Flint* v. *Stone Tracy Company*, 220 U.S. 107, 171, 31 S. Ct. 342, 357, 55 L. Ed. 389, *Ann. Cas.*1912B, 1312. The difficulty centers around the problem that petitioner here was engaged in a profession which admittedly occupied all of his business hours, but there is such a thing as carrying on a business through agents which is in fact a common practice. The question is one of degree, or "where to draw the line." *Irwin* v. *Gavit*, 268 U.S. 161, 45 S. Ct. 475, 476, 69 L. Ed. 897. Justice Holmes there said that a question of degree was the only one worth arguing in the law.

In its findings of fact the Board found petitioner had gross rentals from the leasehold ranging from $33,983.69 in 1934 down to $19,349.78 in the nine months of 1938. Excluding ground rent and taxes, the Board found petitioner had operating expenses ranging from $15,902.33 in 1934 to $6,557.03 in 1938. In the schedule of receipts and expenditures in the operation of the property, it is shown that petitioner paid out in wages in 1934, $10,346.17; 1935, $10,229.06; 1936, $8,522.98; 1937, $1,596.67; 1938, $750.02. Petitioner sustained a net operating loss for the years 1934 to and including 1937, and for 1938, a net profit.

It is a fair inference from the evidence that petitioner acquired the leasehold with the primary intention of operating the building upon it for profit and that he was not holding the property merely as an investment and solely for the purpose of collecting rents without rendering personal service to tenants. The fact may not be disputed that a person may engage in both a profession and a business [*Mente* v. *Eisner*, 2 Cir., 266 F. 161, 11 A.L.R. 496] and the fact that petitioner was engaged in the practice of law does not at all negative the fact that he was also engaged in the business of operating the building. The management of the property necessarily involved alterations and repairs commensurate with the number of tenants who occupied the building. It was also necessary to furnish elevator service, heat, light and water which required regular and continuous activity and the employment of labor, the buying of material and many other things which come within the definition of business. *Commissioner of Internal Revenue* v. *Boeing*, 9 Cir., 106 F.2d 305.

Petitioner urges that the income arising from the sale of the leasehold is not within the statutory exclusion, because he sold the business as a whole and not merely an asset used in it. This contention is without merit. The purpose of the exclusion provided in the Act is said to be a "recognition of the principle that gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses and, as such directly affect the volume of business profits which should be subjected to tax in the years in which such transactions occur." "This, in the great majority of cases, should be of benefit to the taxpayer since it will allow him to take losses against his ordinary income from the sale of such property. Under existing law, if a taxpayer loses on the sale of depreciable property, he cannot charge it off against ordinary income and can only receive a deduction if he has capital gains." Report of the Committee on Ways and Means on the Revenue Bill of 1938, dated March 1, 1938.*

Under the Board's findings of fact, petitioner was engaged in the business of managing and renting property. He used in that business the present leasehold and when he disposed of it, presumptively he sold an asset used in his business.

Viewing the language of the statute in the light of its purpose, it is clear that petitioner disposed of a business asset. *Richards* v. *Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249.

The case of *Commissioner* v. *Shapiro*, 6 Cir., 125 F.2d 532, relied on by petitioner has no application. It is distinguishable on its facts.

Petitioner relying on the settled rule that no depreciation is allowable under Section 23(*l*) unless the asset has a limited and terminable existence, urges that as the lease in question was renewable forever, its exhaustion is not susceptible to measurement. The concept of a lessening in value or exhaustion attributable

* 39–1 C.B. (Part 2) 752, 732. [Ed.]

entirely to the gradually diminishing life, measured in periods of time, has been applied in determining depreciation of leaseholds under all revenue acts and is specifically applicable under the present act as provided in Treasury Regulations 118, § 39.23(a)-10.

The renewal privileges under the terms of the present lease are qualified and may never be exercised. Under such circumstances, the life of the lease is measurable in time and is a depreciable asset within the purview of the statute. *Bonwit Teller & Co.* v. *Commissioner*, 2 Cir., 53 F.2d 381, 82 A.L.R. 325; *379 Madison Ave.* v. *Commissioner*, 2 Cir., 60 F.2d 68; *Helvering* v. *F. & R. Lazarus Co.*, 308 U.S. 252, 254, 60 S. Ct. 209, 84 L. Ed. 226.

The findings of the Board are supported by substantial evidence. Its order is affirmed.

Note

1. Since 1942, the statute has excluded from the category of capital assets *all* real property used in the trade or business. Section 1221(2). In 1938, the year involved in the *Fackler* case, however, the statute excluded only *depreciable* property used in the trade or business. It was for this reason that the Court had to decide if the leasehold was depreciable. Ordinarily, of course, the taxpayer who owns rental property sells both land and a building. Since only the building is depreciable, the effect of finding that the property was used in the trade or business was (before 1942) to require capital gain or loss to be reported on the land and ordinary income or loss to be reported on the building. To avoid the resulting difficulty of allocating a lump sum sales price between land and building, the statute was amended in 1942 to remove *all* trade and business real estate from the capital asset category. H.R. Rept. No. 2333, 77th Cong., 1st Sess., 42–2, C.B. 372, 445. The price must still be allocated in calculating the buyer's deduction for depreciation.

2. Note that the Court says the taxpayer "was not holding the property merely as an investment and solely for the purpose of collecting rents without rendering personal service to tenants." In *Hazard* v. *Commissioner*, 7 T.C. 372 (1946), the *Fackler* principle was applied to a building originally used as the taxpayer's residence, then rented for four years, and finally sold. (On the "conversion" of personal property to business uses, see *supra*, p. 208.) There was no evidence that the taxpayer owned other rental property, presumably the management of this property occupied even less time than the "one or two" hours monthly devoted by Mr. Fackler to the management of his leasehold. Yet the court determined that, at the time of sale, the property was "used in the trade or business" because rented. For a contrary result on very similar facts, see *Grier* v. *United States*, 120 F. Supp 395 (D. Conn. 1954), where the court said:

> In this case the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair. Lacking the broader activity stressed in . . . *Fackler* v. *Commissioner*, the real estate in this case appears to partake more of the nature of property held for investment than property used in a trade or business. The property in this case, although used for the production of income should not be considered as used in the taxpayer's trade or business.

Do the arguments for special treatment of capital gains and losses suggest how property like that involved in the *Fackler* case should be treated? Is there any reason why a share of stock held by a trader like Mr. Van Suetendael, *supra*, p. 390, should be a capital asset while rental property owned by an investor is not?

2. *Is It a Quasi-Capital Asset?*

Note: **Section 1231 of the 1954 Code is virtually identical with § 117(j) of the 1939 Code.**
See Regs. 188, Sec. 39.117(j)-1.

Until 1942, on a sale or exchange of property the gain (loss) was ordinary income (loss) or capital gain (loss) depending upon whether the property was a capital asset or not. This bipolar classification was abandoned when § 117(j) [now § 1231] was added in 1942. Certain types of property, that would previously have given rise to ordinary income or loss, by virtue of § 1231 now give rise to capital gain or capital loss under certain circumstances.

Section 1231 should be examined with some care. It throws into a hotchpot all recognized gains or losses:

(a) on the sale, exchange, or "compulsory or involuntary conversion" (including condemnation, requisition, seizure, theft, and destruction) of depreciable and real property used in the trade or business and held for more than six months (excluding property includible in inventory or held for sale to customers and most copyrights and similar property);

(b) on the "compulsory or involuntary conversion" of capital assets, held for more than six months; and

(c) on the sale or exchange of certain livestock, unharvested crops, timber, iron ore, and coal.

If the hotchpot just described shows a net gain, then all gains and losses therein are treated as capital gains and losses; if it produces a net loss, the individual items are treated as ordinary income and ordinary losses.

Returning to *Fackler* v. *Commissioner*, *supra*, p. 402, if the taxpayer's transaction had occurred in 1942 or thereafter and had been his only "§ 1231 transaction" for the year, the profit would have been capital gain. If there had been a loss, however, it would have been an ordinary loss. But if there were other § 1231 transactions during the year, the treatment of profit or loss on the transaction in question would depend on the outcome of the hotchpot computation. To the extent that the taxpayer can postpone or accelerate his § 1231 transactions, he can determine the outcome of the hotchpot in a given taxable year and thus insure for himself a happy succession in alternate years of capital gains and ordinary losses.

Section 1231's extraordinary operation cries out for a rationale.

WELLS
LEGISLATIVE HISTORY OF TREATMENT OF CAPITAL GAINS UNDER THE FEDERAL INCOME TAX

2 Nat'l. Tax J. 12, 31–2 (1949)
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Section 117(j), originally formulated to apply only to involuntary conversions, had been extended during the development of the 1942 act to ordinary sales and exchanges of depreciable property and finally to real property used in the trade or business, whether depreciable or not. The Ways and Means Committee bill limited special treatment to involuntary conversions and depreciable assets other than buildings and similar real estate improvements. The increase in involuntary conversions during the war, chiefly through shipping losses and condemnation of property for military purposes, had brought up the problem of providing special treatment for involuntary conversions. The expansion of the provision to cover ordinary sales and exchanges of depreciable property used in trade or business was intended to offer a solution to problems

raised by sales under wartime conditions. The 1938 exclusion of depreciable property from capital gains treatment had been intended to give full loss offset to sales of machinery and equipment used in trade or business. In ordinary times, no gains are realized upon such sales, but because of the war situation many taxpayers were selling buildings, machinery, and other equipment at substantial gains. Many of these sales involved an involuntary element. In considering the types of property to which section 117(j) should be extended on voluntary sale or exchange, the troublesome distinction between real property [*i.e.*, land] and depreciable property reappeared. The Senate bill in line with the view that uniform treatment should apply to both types of business property extended the section to cover not only depreciable property but also real property used in the trade or business. In addition, the lenient treatment thus provided for gains removed a principal objection to the Senate classification of real property as a noncapital asset, namely tax interference with gainful sales. The Senate version was adopted.

Note

1. Section 1231 is ordinarily favorable to the taxpayer, since it holds out the possibility of capital gain treatment on assets like business real estate and depreciable personalty that would otherwise be ineligible. The gain on such assets, moreover. may be merely a recoupment of excessive depreciation deducted from ordinary income in earlier years.

But § 1231 can also work against the taxpayer's interest. Suppose in a given taxable year the taxpayer suffers a loss of $10,000 on the sale of an apartment house and a gain of $8,000 on the sale under threat of condemnation of his own residence, both items having been held for more than six months. Were it not for § 1231, the $10,000 ordinary loss on the apartment house could be used to wipe out $4,000 of the long term capital gain on his home (the other $4,000 being deducted under § 1202), and he would be left with a $6,000 loss to be applied against his other income. By reason of § 1231, however, both items are treated as non-capital assets· the result is that after applying his $10,000 loss against his $8,000 gain, the taxpayer has only $2,000 of loss to apply against his other income. If the taxpayer's profit on the sale under threat of condemnation of his residence had been $25,000 instead of $8,000, § 1231 would also be unfavorable. For then, were it not for § 1231, he would have had an ordinary loss of $10,000 to apply against the taxable half of his capital gain, leaving only $2,500 to be taxed. Under § 1231, however, both items are capital, the result is that the taxpayer has a net long-term capital gain of $15,000, of which 50 per cent will be taxed.

By and large, however, § 1231 is favorable to the taxpayer. The adverse impact just noted could sometimes be avoided by postponing one transaction from one year to another.

2. There has been a flurry of recent litigation over the status of real property originally held for rental but then sold. At what point does such property come to be "held by the taxpayer primarily for sale to customers" in the ordinary course of his trade or business? When it is so held, it is no longer eligible for the benefit of § 1231. See *Rollingwood Corp.* v. *Commissioner*, 190 F.2d 263 (9th Cir. 1951); Brodsky, "Sale of Houses Originally Built for Investment, or Whither Section 117(j)?" 12th *Annual N.Y.U. Inst. on Fed. Taxation* 109 (1954).

3. Another recent group of cases has concerned the nature of the income realized by a farmer who sells farmland with an unharvested crop for a lump sum. If there is a profit on the sale, and if the sale is the taxpayer's only transaction under § 1231 for the taxable year, is the profit taxable as a capital gain under § 1231, or must the profit allocable to the crop be taxed as ordinary income on the theory that the crop, even though unharvested and unripe, is held primarily for sale to customers? In *Watson* v. *Commis-*

sioner, 345 U.S. 544 (1953), the Supreme Court held that the profit on the crop must be taxed as ordinary income. Under a line of lower court cases to the contrary, the taxpayer might have had a taxable loss despite his enjoyment of an economic gain. Assume that the land cost $10,000, that the expenses of raising the crop were $2,000, that the "package" is sold for $13,000, and that the sales price is allocable $10,000 to the land and $3,000 to the crop. Under the decisions rejected by the *Watson* case, the farmer would have $3,000 of capital gain, of which 50 per cent could be deducted under § 1202,* and $2,000 of expenses deductible under § 162(a). The Revenue Act of 1951 added §§ 1231(b)(4), 268, and 1016(a)(11) to the Code; they have the effect of allowing capital gain on the sale, but at the expense of capitalizing the costs of raising the crop. How would the example just given be affected by these sections? See Halstead, "Capital Gains of Farmers," 25 *So. Calif. L. Rev.* 36, 37–57 (1951).

3. *The Requirement of a Sale or Exchange*

JAMISON v. COMMISSIONER

Tax Court of the U. S., 1947
8 T.C. 173

Johnson, Judge. Issue No. 1. In computing petitioner's taxable income, the Commissioner disallowed the deduction of $7,300 claimed for 1942 as a loss sustained by the abandonment of 3 lots in Brigantine, New Jersey, and the deduction of $3,000 claimed for 1943 as a loss sustained by the abandonment of 31 lots near Morehead, North Carolina. Respondent does not dispute the amounts of the losses claimed and that petitioner deeded the lots to the respective states in order to avoid payment of taxes, as the evidence establishes. But he contends that these losses are capital in nature, and that their deduction is subject to § 117(d)(2) [now § 1211(b)], which imposes a limitation equal to the taxpayer's capital gains or $1,000, whichever is smaller. As petitioner for each year sustained other capital losses in excess of $1,000, the maximum deduction was absorbed by them, and the losses in controversy were disallowed in full.

Petitioner assails the determination that the deductions claimed involved losses from the sale or exchange of capital assets as defined by section 117(a). He contends that as to the 3 lots in Brigantine, New Jersey, and the 31 lots in North Carolina, he is entitled to a deduction for the full loss on these properties, since there was no sale or exchange, but rather an abandonment, and under the circumstances the loss is an ordinary one and not subject to the limitation of $1,000 prescribed in § 117(d) of the code. He cites *Commonwealth, Inc.*, 36 B.T.A. 850, and *James B. Lapsley*, 44 B.T.A. 1105, as supporting the deduction of an ordinary loss under the circumstances shown. In these cases this Court held that an ordinary loss resulted where the owner of realty subject to a mortgage deeded the property to the mortgagee without consideration and thereby sustained a loss, since the owner was not personally liable for the indebtedness covered by the mortgage.

Respondent asserts in his brief "that in conveying title to the taxing authorities petitioner was making a forced conveyance which the courts hold the equivalent of a foreclosure sale," and cites *Helvering* v. *Nebraska Bridge Supply*

* Deduction under § 1202 assumes either that the crop can be regarded as held for more than six months or that the holding period of the land governs the whole transaction.

& Lumber Co. (1941), 312 U.S. 666, and *Helvering* v. *Hammel* (1941), 311 U.S. 504.

In the pending case there was nothing to indicate a "forced conveyance," as there was no evidence that the taxing authorities had brought or threatened foreclosure of the tax lien, but, on the contrary, it appears that the taxpayer's action in deeding both properties was voluntary and he manifested to the taxing authorities his desire to deed the properties as he wished to abandon same, having decided that their value was less than the taxes thereon.

The laws of New Jersey and North Carolina, in which two states these properties are located, both expressly provide that there is no personal liability against the owners of realty for taxes due thereon. The dollar consideration recited not being paid and petitioner not being personally liable for the taxes, the conveyances of both properties were without consideration. As was said in *Commonwealth, Inc., supra.*

> Inasmuch as there was in fact no consideration to the petitioner, the transfer of title was not a sale or exchange The execution of the deed marked the close of a transaction whereby petitioner abandoned its title.

The cases of *Helvering* v. *Hammel* and *Helvering* v. *Nebraska Bridge Supply & Lumber Co., cited* by respondent, are clearly distinguishable from this case. In both of these cases the title to the property passed, not by a deed voluntarily executed without consideration for an abandonment of the property, but in the former by virtue of a foreclosure sale, based upon a court decree foreclosing the lien, and in the latter by tax sale. In the *Hammel* case the taxpayer was one of a syndicate which defaulted in payment of indebtedness secured by lien on realty. The holder of the indebtedness obtained judgment and a foreclosure decree without equity of redemption and thereafter the "Sheriff sold the property at public auction" and the taxpayer lost the amount he had invested therein. The taxpayer contended, and the Circuit Court held, 108 Fed. (2d) 753, that, since the taxpayer was not a party to the sheriff's sale and neither contracted for nor consented to it and received no part of the consideration and was deprived of his interest in the property, not by sale, but by adverse judicial proceeding, the sheriff's sale was not a sale within the meaning of section 117(d). The Supreme Court, however, reversed the Circuit Court and held that the word "sale" in section 117(d) was comprehensive enough to cover a *forced sale* or a sale foreclosing the lien and was not restricted to a private or voluntary sale, as had theretofore been held. We quote from the Supreme Court's opinion in the *Hammel* case:

> . . . *the sale* was the definitive event establishing the loss within the meaning and for the purpose of the revenue laws. They are designed for application to the practical affairs of men. *The sale*, which finally cuts off the interest of the mortgagor and is the means for determining the amount of the deficiency judgment against him is a means adopted by the statute for determining the amount of his capital gain or loss from *the sale* of the mortgaged property. [Italics supplied]

In the *Nebraska Bridge* case, *supra*, the taxpayer owned land upon which there were delinquent taxes secured by a tax lien, but no personal liability against the owner, and the taxpayer's property was divested, not by a conveyance without consideration, but the state foreclosed its lien and "the lands were bought in by the state at a regular tax *sale* for the amount of the delinquent taxes."

The Circuit Court of Appeals for the Eighth Circuit, at 115 Fed.(2d) 288, held in favor of the taxpayer that such transaction did not constitute a sale and that the loss was an ordinary one and not limited by section 117(d), but the Supreme Court, following its decision in the *Hammel* case, decided shortly prior thereto, reversed the judgment of the Circuit Court without a written opinion. . . .

In *Stokes* v. *Commissioner*, 124 Fed.(2d) 335, the Circuit Court of Appeals for the Third Circuit held that if the taxpayer who is not personally liable conveys the mortgaged premises to the mortgagee, who accepts the deed without paying or promising to pay anything therefor, the transaction is not a "sale" or "exchange" within the meaning of section 117(d). In that case, as in the pending one, the Commissioner contended that the *Hammel* and the *Nebraska Bridge* cases were in conflict with such holding, and the opinion of the Circuit Court in the *Stokes* case, in answering such argument, used this language:

> It is contended on behalf of the Commissioner that the case is governed by *Helvering* v. *Nebraska Bridge Supply & Lumber Co.* (1941), 312 U. S. 666, 667, 61 S. Ct. 827, 85 L. Ed. 1111, which follows *Helvering* v. *Hammel* (1941), 311 U. S. 504, 61 S. Ct. 368, 85 L. Ed. 303, 131 A. L. R. 1481, and *Electro-Chemical Engraving Co., Inc.* v. *Commissioner of Internal Revenue* (1941), 311 U.S. 513, 61 S. Ct. 372, 85 L. Ed. 308. Each of these cases, however, involved a sale, i. e., a foreclosure sale or a tax sale; the only issue being whether such forced sales were outside the contemplation of Congress in referring to sales. . . .

We therefore hold that petitioner sustained ordinary and not capital losses in 1942 as to the Brigantine lots and in 1943 as to the North Carolina lots and is entitled to deduction for the full amount of his losses on both.

Note

1. *Should* there be any tax difference between a foreclosure of a tax or mortgage lien and a "voluntary" abandonment or conveyance to the lienor? Can the taxpayer whose real estate has become worthless take a deduction under § 165(a) without abandoning or transferring it and thereby avoid even the semblance of a "sale or exchange?" In *Helvering* v. *Gordon*, 134 F.2d 685 (4th Cir. 1943), the Commissioner argued that real estate could not give rise to a loss until the taxpayer divests himself of title. Although admitting that in the case of other property, actual worthlessness permits a deduction even though the property is not disposed of in any way, he argued that "real estate always has potential value" so that no closed transaction is shown while the taxpayer continues to own the property. The Court said:

> Assuming the truth of this assertion with respect to an unencumbered interest in land, it cannot stand the practical or realistic test which is met when the interest is subject to superior liens or encumbrances that exceed its real value. In such a case the value of the equity is extinguished as effectually as the interest which a stockholder retains who holds title to shares in an insolvent corporation that has no reasonable expectation of recovery. In one case, as in the other, the loss has taken place and the retention of the bare legal title becomes a circumstance without significance.

Recall that by virtue of Section 165(g) the loss on stocks and other securities that become worthless are capital losses. *Infra*, p. 396. There is no comparable provision for other kinds of property.

2. Condemnation has been held to constitute a sale or exchange. *Hawaiian Gas Products Ltd.* v. *Commissioner*, 126 F.2d 4 (9th Cir. 1942). If it were not, there would be an unwarranted disparity between condemnation and sales under threat of condem-

nation. Their similarity has received statutory recognition; both § 1033 and § 1231 put them on a plane of equality. Where property is destroyed and the taxpayer is compensated by an insurer, however, the Supreme Court has held that there is no sale or exchange. *Helvering* v. *Flaccus Oak Leather Co.*, 313 U.S. 247 (1941). Here again § 1231 puts the involuntary transaction on a par with a sale. What if property is stolen and the owner waives the tort and sues for and recovers the value of the property?

3. See generally Note, The Elements of a Section 117 "Sale or Exchange," 53 *Col. L. Rev.* 976 (1953).

4. *Is the Gain or Loss Recognized?*

> ***Note:*** **Section 1031(a) of the 1954 Code, relating to certain exchanges, in kind, reenacts, without substantive change, § 112(b)(1) of the 1939 Code.**
> **See Regs. 118, Sec. 39.112(b)(1)-1.**

We have already seen that the Code provides for the non-recognition of gain and/or loss in a diversity of transactions with securities. Gain or loss in certain real estate transactions also goes unrecognized. Two examples of non-recognition have already been encountered: the gain on sale of a residence if another is purchased within a year (*supra*, p. 155); and the gain on an involuntary conversion when the taxpayer elects to come under § 1033 (*supra*, p. 156). The following case illustrates another non-recognition provision: § 1031. Like § 1033 it is not limited to capital assets, but it is nevertheless conveniently examined here. § 1031, unlike both § 1033 and § 1034, provides for the non-recognition of both gain *and loss*. Moreover, unlike § 1033, it is not elective.

CENTURY ELECTRIC CO. v. COMMISSIONER

U. S. Court of Appeals, Eighth Circuit, 1951
192 F.2d 155, cert. den. 342 U.S. 954 (1952)

Before SANBORN, JOHNSEN and RIDDICK, Circuit Judges.

RIDDICK, Circuit Judge.

The petitioner, Century Electric Company, is a corporation engaged principally in the manufacture and sale of electric motors and generators in St. Louis, Missouri. It is not a dealer in real estate. As of December 1, 1943, petitioner transferred a foundry building owned and used by it in its manufacturing business and the land on which the foundry is situated to William Jewell College and claimed a deductible loss on the transaction in its tax return for the calendar year 1943. The Commissioner of Internal Revenue denied the loss. The Commissioner was affirmed by the Tax Court and this petition for review followed.

The opinion of the Tax Court and its findings of fact, stated in great detail, are reported in 15 T.C. 581. Petitioner accepts the Tax Court's findings of fact as correct.

Since its organization in 1901 petitioner has been continuously successful in business. In its income tax return for the year 1943 it reported gross sales of $17,004,839.73 and gross profits from sales of $5,944,386.93. On December 31, 1942, petitioner owned land, buildings, and improvements of the total depreciated cost of $1,902,552.16. On December 31, 1943, its actual cash on hand amounted to $203.123.70. During the year 1943 it distributed cash dividends

of $226,705.69 and made a contribution to Washington University of $42,500. It also held tax anticipation notes and Series G bonds totaling $2,000,000, readily convertible into cash and sufficient to liquidate its outstanding 1943 tax liability and its two outstanding 90-day bank notes due January 20, 1944.

Petitioner has always operated its business in large part on borrowed capital. In 1943 it had open lines of credit with the Chase National Bank of New York of $300,000, with the Boatmen's National Bank of St. Louis of the same amount, and with the Mercantile-Commerce Bank and Trust Company of $400,000. At the end of 1943 its outstanding loans from the Mercantile bank amounted to $600,000 approved by the authorized officers of the bank. Petitioner has always been able to liquidate its outstanding 90-day bank loans as they become due either by payment or renewal.

The assessed value of petitioner's foundry building and land upon which it is located for 1943 was $205,780. There was evidence that in St. Louis real property is assessed at its actual value. There was also evidence introduced by petitioner before the Tax Court that the market value for unconditional sale of the foundry building, land, and appurtenances was not in excess of $250,000.

As of December 1, 1943, the adjusted cost basis for the foundry building, land, and appurtenances transferred to William Jewell College was $531,710.97. The building was a specially designed foundry situated in a highly desirable industrial location. It is undisputed in the evidence that the foundry property is necessary to the operation of petitioner's profitable business and that petitioner never at any time considered a sale of the foundry property on terms which would deprive petitioner of its use in its business.

Petitioner's explanation of the transaction with the William Jewell College is that in the spring of 1943 a vice-president of the Mercantile bank where petitioner deposited its money and transacted the most of its banking business suggested to petitioner the advisability of selling some of its real estate holdings for the purpose of improving the ratio of its current assets to current liabilities by the receipt of cash on the sale and the possible realization of a loss deductible for tax purposes. Petitioner's operating business was to be protected by an immediate long-term lease of the real property sold.

Petitioner's board of directors rejected this proposition as unsound. But in July 1943, when a vice-president of the Mercantile bank suggested to petitioner's treasurer that it would be a good idea for petitioner to pay off all its bank loans merely to show that it was able to do so, petitioner interpreted this advice as a call of its bank loans. Acting on this interpretation, petitioner borrowed from the First National Bank in St. Louis on the security of tax anticipation notes held by it, funds with which it discharged all its bank loans. Immediately thereafter it re-established its lines of bank credit and began consideration of a sale of the foundry property and contemporaneous lease from the purchaser.

On September 2, 1943, petitioner's board of directors adopted a resolution that the executive committee of the board study the situation "and present, if possible, a plan covering the sale and rental back by Century Electric Company of the foundry property." The decision to enter into the transaction described was communicated to the Mercantile bank, but petitioner never publicly offered or advertised its foundry property for sale. The Tax Court found that petitioner "was concerned with getting a friendly landlord to lease the property back to

it, as there was never any intention on the part of petitioner to discontinue its foundry operations." Several offers to purchase the foundry property at prices ranging from $110,000 to $150,000 were received and rejected by petitioner.

At a special meeting of the board of directors of petitioner on December 9, 1943, the president of petitioner reported that the officers of petitioner had entered into negotiations for the sale of the foundry property to William Jewell College for the price of $150,000 with the agreement of said college:

> that in addition thereto said Trustees of William Jewell College further have agreed to execute a lease of the property so purchased to Century Electric Company for the same time and on substantially the same terms and conditions which were authorized to be accepted by the special meeting of shareholders of this corporation, held on the 24th day of November, 1943.

The stockholders at the November meeting had authorized the sale of the foundry property at not less than $150,000 cash, conditioned upon the purchaser executing its lease of the property sold for a term of not less than 25 and not more than 95 years. The Board by resolution approved the proposed transaction with the William Jewell College, but on condition that

> this corporation will acquire from Trustees of William Jewell College, a Missouri Corporation, an Indenture of Lease . . . for a term of not less than twenty-five years and for not more than ninety-five years.

The resolution set out in detail the terms of the lease from the college to petitioner, approved the form of the deed from the petitioner to the college, authorized the president and secretary of petitioner to execute the lease after its execution by the trustees of the college, and directed

> that the president and secretary of this corporation be authorizd to deliver said Warranty Deed to said purchaser upon receiving from said purchaser $150,000 in cash, and upon receiving from said purchaser duplicate executed Indenture of Lease on the forms exhibited to this Board.

The resolution provided that the deed and lease should be dated December 1, 1943, and effective as of that date.

The deed and the lease were executed and delivered as provided by the resolution of petitioner's board of directors. Neither instrument referred to the other. The deed was in form a general warranty deed, reciting only the consideration of $150,000 in cash. The lease recited among others the respective covenants of the parties as to its term, its termination by either the lessor or lessee, and as to the rents reserved.

As of Decmber 31, 1942, the ratio of petitioner's current assets to its current liabilities was 1.74. The $150,000 in cash received by petitioner on the transaction increased the ratio of current assets to current liabilities from 1.74 to 1.80. The loss deduction which petitioner claims on the transaction and its consequent tax savings would if allowed have increased the ratio approximately twice as much as the receipt of the $150,000.

The questions presented are:

1. Whether the transaction stated was for tax purposes a sale of the foundry property within the meaning of section 112 of the Internal Revenue Code, on which petitioner realized in 1943 a deductible loss of $381,710.97 determined under section 111 of the code (the adjusted basis of the foundry property of

$531,710.97 less $150,000) as petitioner contends; or, as the Tax Court held, an exchange of property held for productive use in a trade or business for property of a like kind to be held for productive use in trade or business in which no gain or loss is recognized under sections 112(b)(1) and 112(e), and Regulation 118, section 39.112(b)(1)-1.[1]

2. Whether if the claimed loss deduction is denied, its amount is deductible as depreciation over the 95-year term of the lease as the Tax Court held, or over the remaining life of the improvements on the foundry as the petitioner contends.

On the first question the Tax Court reached the right result. The answer to the question is not to be found by a resort to the dictionary for the meaning of the words "sales" and "exchanges" in other contexts, but in the purpose and policy of the revenue act as expressed in section 112. Compare *Federal Deposit Insurance Corp.* v. *Tremaine*, 2 Cir., 133 F.2d 827, 830; *Cabell* v. *Markham*, 2 Cir., 148 F.2d 737, 739; *Markham* v. *Cabell*, 326 U.S. 404, 409, 66 S. Ct. 193, 90 L. Ed. 165; *Brooklyn National Corp.* v. *Commissioner*, 2 Cir, 157 F.2d 450, 451; *Emery* v. *Commissioner*, 2 Cir., 166 F.2d 27, 30, 1 A.L.R.2d 409. In this section Congress was not defining the words "sales" and "exchanges." It was concerned with the administrative problem involved in the computation of gain or loss in transactions of the character with which the section deals. Subsections 112(b) (1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See *Fairfield S.S. Corp.* v. *Commissioner*, 2 Cir., 157 F.2d 321, 323; *Trenton Cotton Oil Co.* v. *Commissioner*, 6 Cir., 147 F.2d 33, 36. For tax purposes the question is whether the transaction falls within the category just defined. If it does, it is for tax purposes an exchange and not a sale. So much is indicated by subsection 112(b) (1) with regard to the exchange of securities of readily ascertainable market value measured in terms of money. Gain or loss on exchanges of the excepted securities is recognized. Under § 112(e) [now § 1031(c)] no loss is recognized on an exchange of property held for productive use in trade or business for like property to be held for the same use, although other property or money is also received by the taxpayer. Compare this subsection with § 112(c)(1) [now 1031(b)] where in the same circumstances gain is recognized but only to the extent of the other property or money received in the transaction. The comparison clearly indicates that in the computation of gain or loss on a transfer of property held for productive use in trade or business for property of a like kind to be held for the same use, the market value of the properties of like kind involved in the transfer does not enter into the equation.

The transaction here involved may not be separated into its component parts

[1] "Sec. 39.112(b)(1)-1. Property Held for Productive Use in Trade or Business or for Investment.—As used in section 112(b) (1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. . . .

"No gain or loss is recognized if . . . (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate. . . ."

for tax purposes. Tax consequences must depend on what actually was intended and accomplished rather than on the separate steps taken to reach the desired end. The end of the transaction between the petitioner and the college was that intended by the petitioner at its beginning, namely, the transfer of the fee in the foundry property for the 95-year lease on the same property and $150,000.

It is undisputed that the foundry property before the transaction was held by petitioner for productive use in petitioner's business. After the transaction the same property was held by the petitioner for the same use in the same business. Both before and after the transaction the property was necessary to the contined operation of petitioner's business. The only change wrought by the transaction was in the estate or interest of petitioner in the foundry property. In Regulations 118, section 39.112(b) (1)-1, the Treasury has interpreted the words "like kind" as used in subsection 112(b) (1). Under the Treasury interpretation a lease with 30 years or more to run and real estate are properties of "like kind." With the controlling purpose of the applicable section of the revenue code in mind, we can not say that the words "like kind" are so definite and certain that interpretation is neither required nor permitted. The regulation, in force for many years, has survived successive reenactments of the internal revenue acts and has thus acquired the force of law. *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 466, 53 S. Ct. 435, 77 L. Ed. 893; *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 116, 59 S. Ct. 423, 83 L. Ed. 536; and see *Commissioner of Internal Revenue* v. *Crichton*, 5 Cir., 122 F.2d 181.

On the second question the Tax Court held that petitioner was not entitled to depreciation on the improvements on the foundry property over their useful life after December 1, 1943. The answer to this question depends upon whether as a result of the transaction under consideration the petitioner has an indentifiable capital investment in the improvements on the land covered by the lease. Petitioner contends that the amount of its claimed loss, $381,710.97, should be apportioned between the land and improvements in proportion to their respective cost bases as of November 30, 1943. This would result in an allocation of $277,076.68 of petitioner's investment in the leasehold to the improvements and $104,634.29 to the land. The difficulty with petitioner's position is that it involves assumptions and inferences which find no support in the record. What the petitioner has done is to exchange the foundry property having an adjusted basis of $531,710.97 on December 1, 1943, for a leasehold and $150,000 in cash. Its capital investment is in the leasehold and not its constituent properties. Accordingly, we agree with the Tax Court that petitioner is entitled to depreciation on the leasehold. The basis for depreciation of the leasehold on December 1, 1943, is, therefore, $381,710.97 under section 113(a) (6) [now § 1031(d)], deductible over the term of the lease.

The decision of the Tax Court is affirmed.

Note

Was § 1031(a) necessary to the result? In two cases where the sale was coupled with a lease-back for less than 30 years, the period mentioned in Regulations 118, Sec. 39.112(b)(1)-1, the loss has been allowed by the Tax Court, *Standard Envelope Mfg. Co.* v. *Commissioner*, 15 T.C. 41 (1950); *May Department Stores Co.* v. *Commissioner*, 16 T.C. 547 (1951). The many ramifications of this somewhat over-advertised device

are well elucidated by Cary, "Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations," 62 *Harv. L. Rev.* 1 (1948), and "Current Tax Problems in Sale, or Gift, and Lease-Back Transactions," *9th Annual N.Y.U. Inst. on Fed. Taxation* 959 (1951). In certain circumstances, non-profit institutions that are otherwise tax-exempt will be taxed on the income they recive from property purchased and then leased-back. Sections 421 and 423. See *infra*, Chapter 7, Section C.

Section D. Tangible Personal Property

The problems arising under § 1221 with respect to tangible personal property are roughly parallel to those relating to real property.

Property held for sale to customers in the ordinary course of the taxpayer's business, and property includible in inventory, give rise to ordinary income and loss. See *Reynolds* v. *Commissioner*, 155 F.2d 620 (1st Cir. 1946). The Tax Court holds that such property does not become a capital asset when the taxpayer goes out of business and sells it in the process of liquidation. *Grace Bros., Inc.* v. *Commissioner*, 10 T.C. 158 (1948); the opinion of the Court of Appeals affirming this decision is confusing on the question, 173 F.2d 170, 178, (9th Cir. 1949). Note that the process of liquidation may itself become a trade or business and the property being disposed of may be held for sale to customers, as in the *Mauldin* case, *supra*, p. 398.

Tangible personal property used in the trade or business, if depreciable, is also excluded from the capital asset category. (Note that non-depreciable personalty so used, unlike non-depreciable real property used in trade or business, is a capital asset.) Such property, however, is eligible for § 1231; indeed, as pointed out above, *supra*, p. 406, a major purpose of § 1231 was to grant favorable treatment to machinery, equipment, and vessels that were sold or requisitioned during World War II.

A troublesome problem in the application of § 1231 has been to ascertain when property used in the trade or business is also includible in inventory or held for sale to customers, since if it is, § 1231 does not apply. See § 1231(b)(1)(A) and (B). In *Benetti Novelty Co.* v. *Commissioner*, 13 T. C. 1072 (1949), it was held that a taxpayer whose business was renting slot machines was entitled to employ § 1231 on selling used machines; the government had argued that because the taxpayer's regular practice was to sell its older machines and replace them with new ones, the machines were not only used in the trade or business but also held for sale to customers. The Bureau apparently will not accept this decision; see Rev. Rul. 108, 53-1 C.B. 185 (§ 1231 not applicable to automobiles sold by a taxpayer in the business of leasing them for less than their normal useful life and then selling them); I.T. 4062, 51-2 C.B. 61 (automobiles used by a dealer as "demonstrators" are not eligible under § 1231); *cf. Latimer-Looney Chevrolet* v. *Commissioner*, 19 T.C. 120 (1952) ("company cars" used by a dealer for various purposes but customarily sold after 8,000 to 12,000 miles of service are not excluded from § 1231.

A sizeable volume of litigation was concerned with the application of this

distinction to livestock prior to the Revenue Act of 1951, which added what is now Section 1231(b)(3). Animals held exclusively for breeding purposes are depreciable property used in the trade or business and even though sold when their usefulness for breeding is exhausted are not *held* for sale. Hence they have always qualified under § 1231. But suppose a farmer's practice is to use a substantial number of all the animals he raises for breeding and to sell them after a season or two. Are such animals then not only used in the trade or business but at the same time held primarily for sale, and thus ineligible under § 1231? The Treasury's attempt to deny capital gain treatment under § 1231 was on the whole unsuccessful in the courts, but it litigated the issue so persistently that Congress finally intervened in 1951 to insure § 1231's applicability. The leading case under § 1231 prior to its amendment is *Albright* v. *United States*, 173 F.2d 339 (8th Cir. 1949); and see Halstead, "Capital Gains of Farmers," 25 *So. Calif. L. Rev.* 36, 57-64 (1951).

Under § 1231 as amended (the change was retroactive to January 1, 1942), the livestock owner is assured of capital gains treatment if the animals are held for draft, breeding, or dairy purposes even though they are also held for sale. The inclusion of these animals under § 1231 is a shining example of bartering deductions from ordinary income for capital gains. The cost of raising the animals is deductible from ordinary income (unless the farmer inventories his animals); the profit on sale is capital gain. To illustrate by an extreme example, assume that the cost of raising an animal is $100, deducted from income that would otherwise be taxed at the rate of 50 per cent, and that the animal is sold for $100. Has the owner made a profit? What if he sells the animal for $80?

The third category of tangible personal property is made up of capital assets. This category includes property devoted to personal use (private automobiles, furniture, jewelry, *etc.*), property held for investment, and non-depreciable property used in the trade or business but not held for sale.

Section E. Patents, Copyrights, and the Like

1. *Before 1950*

Until 1950, the Code did not explicitly prescribe the tax treatment of patents, inventions, copyrights, manuscripts, and similar property. Capital gains and losses would be realized only if, under the general provisions of the statute, the patent, copyright, or other item was a "capital asset" and was "sold or exchanged."

To meet the first requirement—that the property be a capital asset—the taxpayer had to show that it was neither held for sale to customers in the regular course of trade or business nor depreciable property used in his trade or business. In general, capital gains were thus confined to "amateur" inventors and authors, though this category might embrace a person who was employed to invent or write if the work sold was the result of spare-time work outside the scope of his employment. See *Myers* v. *Commissioner*, 6 T.C. 258, 266 (1946); *Pike* v. *United States*, 101 F. Supp. 100 (D. Conn. 1951). Patents and copyrights might also have qualified as "quasi-capital" assets under what is now § 1231, if used in the

trade or business and not held for sale to customers, though this was not entirely clear. See *Avery* v. *Commissioner*, 47 B.T.A. 538 (1942); *Diescher* v. *Commissioner*, 36 B.T.A. 732, 743; *General Spring Corp.* v. *Commissioner*, ¶ 53,257 P-H Memo TC.

Meeting the second requirement—that the capital asset was "sold" or "exchanged"—was easy if the patent or invention was sold for a specified sum. But the typical method of exploiting inventions and literary works is to allow commercial enterprises to use them in return for royalties, and the Internal Revenue Service took the position that a patent or copyright that was licensed for use on a royalty basis was not "sold" or "exchanged" within the meaning of what is now § 1222. This argument was rejected in a number of cases; see, for example, *Dreymann* v *Commissioner*, 11 T.C. 153, 162-163, where the court said:

> We do not agree with respondent's contention that to apply the benefits of the long term capital gains provisions . . . would be repugnant to the "underlying theory of the capital gains limitations." He argues that the purpose of the capital gains limitations is to lessen the impact of the Federal income tax "on the realization in one lump sum in one taxable year of an increment in value which had taken place over a number of years." Since petitioner here did not sell the process for one lump sum, he concludes, the application of the capital gains limitations in the case at bar would defeat the intent and purpose of Congress. In the first place, section 117 of the Revenue Act of 1934 did not contain any provision to the effect that payment from the sale of a capital asset must be in one lump sum. Respondent supports his position, however, by pointing to House Report No. 350, 67th Cong., 1st sess. (C.B. 1939-1 (Part 2), p. 176). That report accompanied the Revenue Act of 1921, which first introduced the capital gains provision into our taxing statute. It reads in part as follows:
>
> > "Section 206: The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. . . ."
>
> There is nothing in the House report or in the Senate report which supports respondent's assertion that a taxpayer, in order to have the tax benefit of the capital gains provisions, must sell his asset for one lump sum. As a matter of fact, this and other courts have held that where, as here, the consideration for the sale of a capital asset was in the form of periodic payments based on a percentage of the gross sales made during the year, the taxpayer was entitled to a capital gains limitation on the sums received in each year. See *Commissioner* v. *Celanese Corporation*, *supra*, *George James Nicholson*, 3 T.C. 596, and cases cited therein. We can find no valid reason for holding otherwise in this case.

See also *Myers* v. *Commissioner*, 6 T.C. 258 (1946), holding that an exclusive license of a patent was a sale, as required for capital gain treatment. The Internal Revenue Service persisted in its view, no doubt much influenced by the anamoly of capital gains being realized for the product of personal service and skill, and in 1950 it issued Mim. 6490, 1950-1 C.B. 9, announcing that royalties were to be treated as ordinary income and withdrawing a previously announced acquiescence in the *Myers* decision.

Up to this point, as indicated above, no distinctions were made between the inventor and the author. From 1950 on, however, it was evident that their paths diverged.

2. *The 1950 Amendments*

Note: Sections 1221(3) and 1231(b)(1)(C), relating to copyrights, literary compositions, and similar property, reenact §§ 117(a)(1)(C) and 117 (j)(1)(C) of the 1939 Code.

In 1948 the financial arrangements for the publication of General Eisenhower's "Crusade in Europe" were extensively discussed in the press. The New Yorker reported:

> The manuscript was finished on March 24th and sold to Doubleday early this month [Oct., 1948] for a sum that has been rumored to be somewhere between a hundred thousand and a million dollars. There hadn't been any doubt that Doubleday would buy the book. The reason for the hiatus, and for an outright sale rather than the usual royalties deal, was a ruling by the income-tax people that in this way Eisenhower would qualify for a twenty-five-per-cent capital-gains tax on the transaction, instead of being subject to the graduated income tax. The capital-gains tax is limited to twenty-five per cent only in the case of so-called capital assets held at least six months, and apparently writers can get in under it when they are non-professionals. If the General should write a second book, he might find himself in the same tax boat as Norman Mailer and Dale Carnegie. We note that he has recently taken up painting, on an amateur basis.

During the 1952 Presidential campaign General Eisenhower made public the Treasury's ruling, which was followed a year later by a closing agreement, to the effect that capital gain would be realized on the assumption that

> you propose to sell to a publisher in one transaction all of your right, title and interest in your literary work, and that after such sale, you would have no further control over the manuscript or its exploitation in any field or medium of publication. . . . that there would be no further income of any kind accruing to you after the single transaction. (New York Times, Oct. 15, 1952, p. 22.)

The emphasis on the sale of all rights for a lump sum reflects the Treasury's view that a royalty arrangement would defeat the concept of a "sale" and that the transfer of book publication rights to one publisher, serial rights to a second, foreign book rights to a third, and dramatic and motion picture rights to others would be indicative of "licenses" and not "sales." See Mim. 6490, *supra;* Fulda, "Copyright Assignments and the Capital Gains Tax," 58 *Yale L.J.* 245 (1949).

About the same time that General Eisenhower's transaction occurred, it was reported that the Columbia Broadcasting Company had lured a number of radio performers, including Amos 'n Andy and Jack Benny, from the National Broadcasting Company, by so-called "capital gains deals." The details have never been authoritatively publicly announced, but it was reported that the performers sold the "shows" — embracing perhaps the scripts, trade names, good will, rights to the characters and manner of rendition, *etc.* — for flat sums, simultaneously entering into long-term employment contracts. Every Broadway and Hollywood columnist had his own explanation of the tax advantages thereby gained: speculation was reported on whether Faust's sale of his soul to the Devil gave rise to ordinary income or capital gain.

The bubble was pricked on January 3, 1949, when the Bureau issued this laconic statement:

> The tax effect of any business transaction is determined by its realities.
> Accordingly, proposals of radio artists and others to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the capital gains provisions of the Internal Revenue Code. Such compensation is taxable at ordinary income tax rates.

See generally Mintz, "Entertainers and the Capital Gains Tax," 4 *Tax L. Rev.* 275 (1949).

The Revenue Act of 1950 added what are now §§ 1221(3) and 1231(b)(1)(C), so as to deny capital gain treatment to copyrights, literary, musical, and artistic compositions, and similar property held either by the creator or by a person, such as a donee, whose basis for the property is determined by reference to the creator's basis. The House of Representatives, proposed to treat inventors like authors, but the Senate Finance Committee demurred:

> Your committee believes that the desirability of fostering the work of such [occasional] inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words "invention," "patent," and "design" have been eliminated. . . (S. Rept. No. 2375, 81st Cong. 2d Sess., 1950–2 C.B. 483, 515.)

Can copyrights, manuscripts, and the like ever qualify for capital gain and loss treatment under the present statute? See *Fidler* v. *Commissioner*, 20 T.C. 1081 (1953) (literary properties purchased as an investment with the hope of a profitable resale held to be capital assets).

It should be noted that § 1302 may provide some tax relief for authors and inventors whose income in a single year represents the fruits of work over a period of 36 months or more. *Infra*, Ch. 8, Sec B (3). Another method of avoiding the telescoping of income is to make an "installment sale" of the copyright or other property. Under § 453(b) the income realized on the sale is taxed as the installments are received. Ex-President Truman, who decided to sell his memoirs after the enactment of § 1221(3), was granted a ruling in late 1953 approving a proposed installment sale under § 453(b). *Infra*, Ch. 8, Sec. B(1).

3. *The 1954 Amendment*

***Note:* Section 1235 of the 1954 Code is new.**

The Senate Report on § 1235 states (p. 439):

> To obviate the uncertainty caused by [Mim. 6490, *supra*, relating to royalties] and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a) [of § 1235], to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment.

What is the meaning and purpose of the requirement in § 1235(a) that the taxpayer transfer "property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such "rights"? Under earlier law, the Treasury was unsuccessful in its contention that a patent or copyright is an indivisible unit that can be "sold" only as a whole. Thus Kathleen Winsor's trans-

fer of the motion picture rights to "Forever Amber" was held to be a "sale," rather than a "license," as the government asserted. *Herwig* v. *Commissioner,* 105 F. Supp. 384 (Ct.Ct. 1952). Apparently a transfer of the exclusive right to exploit a patent in a limited geographical area would also be a "sale." See *Cleveland Graphic Bronze Co.* v. *Commissioner,* 10 T.C. 974, 988 (1948), aff'd. p.c. 177 F.2d 200 (6th Cir. 1949). Do cases like these shed light on the phrase quoted above from § 1235(a)?

Note that the benefits of § 1235 are not restricted to amateur inventors. Can capital gain or loss be realized in connection with patents or inventions apart from § 1235?

See § 1302, giving favorable treatment, within certain limits, to ordinary income "in respect of a particular invention or artistic work created by the individual." When would an inventor make use of this provision?

What is the basis upon which gain or loss on the sale of a patent by its inventor is to be computed? See Regs. 118, Sec. 39.23(1)–7. With respect to "developmental or experimental expenses, etc.," which the regulation treats as the cost of a patent, recall that the Bureau's policy has been to allow the "expensing" of these costs where the taxpayer has done so consistently. *Supra,* p. 277. After deducting such costs, could the taxpayer include them in the patent's basis on the theory that the Bureau should not have allowed the deductions? An *amateur* inventor would probably not be allowed to deduct his costs even under the Bureau's lenient policy

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Section F. Assets Linked with Ordinary Income

RHODES' ESTATE v. COMMISSIONER

U. S. Court of Appeals, Sixth Circuit, 1942
131 F.2d 50

Before HAMILTON, MARTIN, and MCCALLISTER, Circuit Judges.

Per Curiam.

On petition for review of a decision of the United States Board of Tax Appeals, it appears from the record that on November 18, 1937, the Carroll Furniture Company of Atlanta, Georgia, declared a cash dividend of $20.00 per share payable on December 18, 1937, to stockholders of record at 12:00 o'clock noon on November 26, 1937. The taxpayer, Herman W. Rhodes, was the record owner of 600 shares of stock of said company on each of the three said dates.

The taxpayer offered to sell his dividend right for $11,925.00 to C. H. Patton of Memphis, Tennessee, an intimate friend. The offer was accepted and on December 7, 1937, Patton borrowed $12,000.00 from a bank for the purpose of making the purchase and pledged the assigned dividend right as collateral for the loan.

The check in payment of said dividend when issued on December 18, 1939, was made payable to Patton, who indorsed it to the bank from which he had obtained the loan, and the bank stamped the note paid and returned it to Patton.

The question is whether the amount received by the taxpayer from Patton

should be treated as ordinary income as held by the Board, or whether such amount constitutes capital gain which is available as an offset against capital losses as the petitioner contends.

In our opinion under the circumstances here present, the sum received by the taxpayer was not capital gain as that phrase is used in Section 117(b) of the Revenue Act of 1936, but was taxable as ordinary income under Section 22(a) of the Revenue Act of 1936. Compare *Helvering* v. *Horst,* 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655; *Helvering* v. *Eubank,* 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81; *Harrison* v. *Schaffner,* 312 U.S. 579, 61 S. Ct. 759, 85 L. Ed. 1055.

The order of the Board is affirmed.

Note

1. If on December 7th the taxpayer had sold the stock itself, together with the right to receive any dividends paid thereafter, would the dividend be taxed to him when paid? I.T. 4007, 50–1, C.B. 11, apparently takes the position that dividends are taxable to the transferor if there is a transfer after the declaration and record dates. Since he is the person entitled to the dividend as a matter of private law (see Stevens, *Corporations* (2d ed. 1949) §§ 132–33), any sale of stock plus dividend for a lump sum might be broken down for tax purchases into separate sales of the stock and of the dividend right; and the sale of the dividend right might be treated as a sham or ineffective assignment.

Does the principal case point in this direction? What if stock is sold between the date of declaration and the record date, or just before and in anticipation of a dividend declaration? See Regs. 118, Sec. 39.22(a)–1(d); *Falco* v. *Donner Foundation,* 208 F.2d 600 (2d Cir. 1953).

If a bond is sold between interest dates, the seller must report the accrued interest as income; the buyer treats it as return of capital. I.T. 3175, 38–1 C.B. 200; *Fisher* v. *Commissioner,* 209 F.2d 513 (6th Cir. 1954). Should the seller's income in respect of the accrued interest be discounted on the theory that the buyer of the bond in fixing the price he will pay for the bond with accrued interest would shade the price for the latter because it will not be paid to him until the next interest date?

2. Should the taxpayer in the *Rhodes' Estate* case be taxed on $11,925 or on $12,000? If the dividend was sold in one year and paid in another, in which is the taxpayer taxable? In *Gleason* v. *Commissioner,* ¶ 42,572 P-H Memo TC, a taxpayer who engaged in this practice was apparently taxed on the amounts received from his assignee in the years the assignments occurred rather than when the dividends were paid:

> He cannot escape or change the tax upon them [the dividends] by any anticipatory arrangement even though he may anticipate the realization of income by means of a transaction which he chooses to call a sale.

What if the taxpayer sells the dividends not in the hope of getting capital gains but solely to realize the income in an earlier year?

3. Would the same result as in the principal case be reached if the taxpayer sold a claim for a dividend if the obligor corporation's liability or capacity to pay was disputed and the transaction was entirely at arm's length? The *Fisher* case, *supra,* paragraph 1, held that on a sale of notes that were in default, the portion of the sales price allocable to past-due interest is ordinary income:

> The petitioner received substantially all of his defaulted interest when he sold his notes . . . and it was, in the light of the *Horst* case, unimportant that he received it not from the [debtor] corporation but from the purchaser of the notes. (209 F.2d 513, 515.)

4. A taxpayer paid $450,000 for the right to receive the first $550,000 of profits received by the owners of a motion picture. After receiving about $375,000 under this

agreement the taxpayer sold its remaining rights (to about $175,000) for their face amount, when the sale occurred, only a tiny fraction of the $175,000 balance had been earned by the picture, but apparently there was little doubt that the entire amount would be earned. The taxpayer's profit of $100,000 was held to be taxable as capital gain. *Pacific Finance Corp.* v. *Commissioner*, ¶ 53,129 P-H Memo TC.

5. If a bond is issued at a discount, the purchaser's profit when it is retired at face amount is the equivalent of interest. Despite this fact, it was held in *Commissioner* v. *Caulkins*, 144 F.2d 482 (6th Cir. 1944), that the purchaser realizes capital gain when the bond is paid at maturity. The court rested its decision on the statutory provision (§ 117(f) of the 1939 Code; § 1232 of the 1954 Code) that the retirement of a bond is to be treated like a sale or exchange:

> Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain wording of 117(f), it was taxable as a capital gain. A provision that the increment in such cases should be taxable under 22(a) might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation.

Legislative legislation was the result; § 1232 is now qualified to insure that the interest represented by the original discount will be taxed as ordinary income rather than capital gain. The problem did not arise with Series E war bonds (and certain other United States bonds), even though issued at a discount, because § 22(c) of the Second Liberty Bond Act, as amended, 49 Stat. 21 (1935), requires the increment to be reported as ordinary income. The holder, if on the cash basis, may report the income either annually, as the redemption value increases, or at maturity; and if the bond is held for a second 10-year period, he may postpone reporting the income until final maturity. Sections 454(a) and (c).

SALES TO CONTROLLED FOUNDATIONS

Intra-Office Memorandum, Internal Revenue Service, 1948

Reprinted in Hearings Before a Subcommittee of House Committee on Ways and Means 83d Cong., 1st. sess. (1953) pp. 1368–69

In 1941, the Lasdon family group—consisting of about 10 individuals—acquired from their wholly owned corporation, for the consideration of $10,000, certain patents and patent applications relating to sulfadiazine. On the following day they granted to the American Cyanamid Co., an exclusive license to exploit sulfadiazine in return for a royalty of 16 percent of the net sales value thereof, plus 25 percent of royalties received from sublessees, the license to continue for 18 years. On an application made by the Lasdons in 1945, the Bureau ruled that the "inventions and the patents, patent applications and contract rights pertaining thereto" constituted capital assets, that they had been held for more than 6 months, and that gain or loss from the sale thereof would constitute long-term capital gain or loss. About a year and a half later the Lasdons established the Lasdon Foundation, Inc., which was to support certain projects in medical research. In September 1947, this foundation was held to be exempt under section 101 (6) [now § 501(c)(3)]. In that same month, the Lasdons proposed to sell to the foundation the sulfadiazine patents and patent applications and their contract rights under the contract with American Cyanamid for the consideration of $6,500,000, or 90 percent of the payments to be received under the American Cyanamid contract, whichever was the lesser. The foundation would assume the Lasdons' obligation under the 1941 license contract to protect the inventions, and Cyanamid would accept this substitution of the foundation for the Lasdons

individually. The foundation would be prohibited from selling the Cyanamid license contract without the consent of Cyanamid, and the Lasdons would guarantee the foundation's performance of the licensor's obligations under the 1941 contract. On the basis of this proposal, the Lasdons requested a prospective ruling * that this transaction would be deemed to be the sale of a capital asset, the gain therefrom returnable on the installment basis.† In a separate request, the foundation requested that its receipt of proceeds under the Cyanamid license contract would be tax exempt. In March 1948, the Lasdons amended their plan by making the consideration payable by the foundation to be the fixed sum of $6 million payable in equal quarterly sums over a period of 10 years. In September 1947, when the original requests were filed, the foundation had approximately $90,000 worth of assets. Over the life of the Cyanamid license contract the Lasdons have heretofore received from Cyanamid an average of approximately $1,100,000 annually. . . .

There are now pending . . . 4 cases, in addition to this case, all 5 of which involve prospective transactions and have these elements in common: (a) a "seller" who is a taxpaying individual or corporation; (b) a "buyer" which is a tax-exempt corporation; (c) a "sale" by the first to the second of these parties of income-producing property; (d) immediately prior to the transfer, the buyer has no substantial amount of assets; (e) provision is made for the deferred payment of the consideration by the "buyer," and it is obvious that such consideration must be derived from income produced by the property transferred. In all of these cases, the "seller" desires a ruling holding the transaction to be the sale of a capital asset, the proceeds of which are returnable on the installment basis

Note

Would capital gains be barred by § 1235(d) of the 1954 Code? If so, could § 1235 be avoided by (a) a similar transaction with a foundation that is not controlled by the transferor family, or (b) a gift by the inventor to his spouse or children, followed by a transfer by them to a foundation? If § 1235(d) is not a barrier, is there any other obstacle to capital gain treatment? See *Hamme* v. *Commissioner*, 209 F.2d 29 (4th Cir. 1953); MacCracken, "Selling a Business to a Charitable Foundation," 1954 *So. Calif. Tax Inst.* 205.

Does § 1235 make it unnecessary to work so hard to get capital gain from a patent? Could a successful author sell his royalty contract to a foundation?

McALLISTER v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1946
157 F.2d 235, cert. den. 330 U.S. 826 (1947)

Before SWAN, CLARK, and FRANK, Circuit Judges.

CLARK, Circuit Judge.

This petition for review presents the question whether the sum of $55,000 received by petitioner on "transfer" or "surrender" of her life interest in a trust to the remainderman constitutes gross income under I.R.C. § 22(a), or receipts from the sale of capital assets as defined in I.R.C. § 117(a)(1). As we shall see,

* See *infra*, Ch. 9, Sec. A(3)(e). [Ed.]
† See *infra*, Ch. 8, Sec. B(1). [Ed.]

some significance seemingly is attached to a choice between the two words set in quotation marks as a description of the transaction. Petitioner contends that the life estate was a capital asset, the transfer of which resulted in a deductible capital loss, leaving her with no taxable income for the year. A majority of the Tax Court agreed with the Commissioner that the receipt in question was merely an advance payment of income, while four judges dissented, Judges Opper and Disney writing the opposing opinions. 5 T.C. 714.

The will of Richard McAllister established a trust fund of $100,000, the income of which was to be paid to his son John McAllister for life and, on the latter's death without children, to John's wife, the petitioner herein. On her death, the trust was to terminate, the residue going to the testator's wife and his son Richard. The testator died in 1926, his widow in 1935, and John in 1937. Except for stock in the R. McAllister corporation, not immediately salable at a fair price, John left assets insufficient to meet his debts; and in order to obtain immediate funds and to terminate extended family litigation according to an agreed plan, petitioner brought suit in the Court of Chancery of New Jersey to end the trust. The parties then agreed upon, and the court in its final decree ordered, a settlement by which the remainderman Richard, in addition to taking over the stock for $50,000, was to pay petitioner $55,000, with accumulated income and interest to the date of payment, in consideration of her release of all interest in the trust and consent to its termination and cancellation. Receiving payment on July 19, 1940, petitioner, in accordance with the court order, executed a release, providing:

> I do further consent and agree that my estate in the aforesaid trust, created under the third paragraph of the . . . will . . . shall be and the same is hereby terminated absolutely, and I do decline to accept further any benefits therefrom or interest therein.

For the year 1940, she reported a capital loss on the transaction of $8,790.20, the difference between the amount received and the value of the estate computed under I.T. 2076. The Commissioner disallowed the loss and made the deficiency assessment which was upheld by the majority below.

The issue, as stated by the Tax Court and presented by the parties, reduces itself to the question whether the case is within the rule of *Blair* v. *Commissioner of Internal Revenue*, 300 U.S. 5, 57 S. Ct. 330, 81 L. Ed. 465, or that of *Hort* v. *Commissioner of Internal Revenue*, 313 U.S. 28, 61 S. Ct. 757, 85 L. Ed. 1168. In the *Blair* case, the life beneficiary of a trust assigned to his children specified sums to be paid each year for the duration of the estate. The Supreme Court held that each transfer was the assignment of a property right in the trust and that, since the tax liability attached to ownership of the property, the assignee, and not the assignor, was liable for the income taxes in the years in question. The continued authority of the case was recognized in *Helvering* v. *Horst*, 311 U.S. 112, 118, 119, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655, although a majority of the Court thought it not applicable on the facts, and in *Harrison* v. *Schaffner*, 312 U.S. 579, 582, 61 S. Ct. 759, 85 L. Ed. 1055, where the Court very properly distinguished it from the situation where an assignor transferred a portion of his income for a single year. We think that its reasoning and conclusion support the taxpayer's position here. It has been relied upon by other cases cited below which we find indistinguishable from the present case.

Petitioner's right to income for life from the trust estate was a right in the estate itself. Had she held a fee interest, the assignment would unquestionably have been regarded as the transfer of a capital asset; we see no reason why a different result should follow the transfer of the lesser, but still substantial, life interest. As the Court pointed out in the *Blair* case, the life tenant was entitled to enforce the trust, to enjoin a breach of trust, and to obtain redress in case of breach. The proceedings in the state chancery court completely divested her of these rights and of any possible control over the property. The case is therefore distinguishable from that of *Hort* v. *Commissioner of Internal Revenue, supra.* where a landlord for a consideration cancelled a lease for a term of years, having still some nine years to run. There the taxpayer surrendered his contractual right to the future yearly payments in return for an immediate payment of a lump sum. The statute expressly taxed income derived from rent, Revenue Act of 1932, § 22(a); and the consideration received was held a substitute for the rent as it fell due. It was therefore taxed as income.

What we regard as the precise question here presented has been determined in the taxpayer's favor on the authority of the *Blair* case by the Eighth Circuit in *Bell's Estate* v. *Commissioner of Internal Revenue*, 8 Cir., 137 F.2d 454, reversing 46 B.T.A. 484. This case, in turn, has been followed by the Tax Court in *Harman* v. *Commissioner of Internal Revenue*, 4 T.C. 335, acquiesced in by the Commissioner, 1945-6 Int. Rev. Bull. No. 6, p. 1, and by the District Court in *First Nat. Bank & Trust Co. in Macon* v. *Allen, D.C.M.D.*Ga., 65 F. Supp. 128. See also *Quigley* v. *Commissioner of Internal Revenue*, 7 Cir., 143 F.2d 27; *Estate of Camden* v. *Commissioner of Internal Revenue*, 47 B.T.A. 926, affirmed 6 Cir., 139 F.2d 697; *Randall* v. *Randall, D.C.S.D.*Fla., 60 F. Supp. 308, 313, 314.

The Tax Court and the government have attempted to distinguish both the *Bell* and the *Blair* cases on grounds which seem to us to lack either substance or reality. The principal ground seems to be the form the transaction assumed between the parties. Thus the Court says that petitioner received the payment for "surrendering" her rights to income payments, and "she did not assign her interest in the trust, as did petitioners in the *Bell* case." But what is this more than a distinction in words? Both were cases where at the conclusion of the transaction the remaindermen had the entire estate and the life tenants had a substantial sum of money. There surely cannot be that efficacy in lawyers' jargon that termination or cancellation or surrender carries some peculiar significance vastly penalizing laymen whose counsel have chanced to use them. And the fact that the whole affair was embodied in a court decree can add nothing more than a seal of legal validity to it. What was practically accomplished remained the same. And that here, as in the *Bell* case, there was a "surrender" to the remainderman, rather than a "transfer" to third persons as in the *Blair* case, does not change the essentially dispositive nature of the transaction so far as the former property owner is concerned.

Other suggestions seem equally dubious. Thus it is said that the transfer in the *Blair* case was without consideration. But it is hard to see how this affects either the fact or the validity of the transfer; if anything, the odds should favor the conveyance for a consideration—the income of which will yield taxes in the future. Naturally, since there were no capital gains or losses, the *Blair* case does not discuss them. (Actually it cites neither the gross income nor the capital

assets statutes.) But its holding that the assignment leaves no taxable income with the assignor is just as potent here on the like point, even though we do have the further problem posited by the claim of a capital loss. And there was very definitely a consideration paid in the *Bell* case. Next it is urged that there could be no assignment because this was a spendthrift trust where the creator had forbidden assignment or anticipation by a beneficiary. (The form of prohibition here was an express command as to a vested equitable interest, there was no grant of discretionary power to the trustees to withhold income.) But the answer is that it was done by a series of transactions affirmed by the state court. That is, the trust provisions made passing of the interest somewhat more difficult, but not beyond the ingenuity of lawyers, when the parties were agreed. So in the *Blair* case the government argued that the trust was a spendthrift trust under Illinois law. Said the Court, 300 U.S. 5, 10, 57 S. Ct. 330, 332, 81 L. Ed. 465:

> The point of the argument is that, the trust being of that character, the state law barred the voluntary alienation by the beneficiary of his interest. The state court held precisely the contrary. The ruling also determines the validity of the assignment by the beneficiary of parts of his interest. That question was necessarily presented and expressly decided.

Setting the bounds to the area of tax incidence involves the drawing of lines which may often be of an arbitrary nature. But they should not be more unreal than the circumstances necessitate. Here the line of demarcation between the *Blair* and the *Hort* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all would agree that there is some distinction between selling a life estate in property and anticipating income for a few years in advance. It is the kind of distinction stressed in *Harrison* v. *Schaffner*, *supra*, 312 U.S. 579, 583, 61 S. Ct. 759, 762, 85 L. Ed. 1055, where the Court said:

> Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case.

The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate at least is. See 57 *Harv.L.Rev.* 382; 54 *Harv.L.Rev.* 1405; 50 *Yale L.J.* 512, 515. Where the line should be finally placed we need not try to anticipate here. But we are clear that distinctions attempted on the basis of the various legal names given a transaction, rather than on its actual results between the parties, do not afford a sound basis for its delimitation. More rationally, to accept the respondent's contention we ought frankly to consider the *Blair* case as overruled, 50 *Yale L.J.* 512, 518, a position which, as we have seen, the Supreme Court itself has declined to take.

The parties are in conflict as to the valuation of the life estate; and we are returning the case to the Tax Court for computation, without, of course, assuming that there will necessarily be some tax.

Reversed and remanded.

FRANK, Circuit Judge (*dissenting*).

Taxpayer's father-in-law, by his will, created a trust by which taxpayer during her life was to receive the income from a fund of $100,000; the will provided that she was not to dispose of her interest or otherwise to anticipate the income. She joined with others interested in the trust to demolish it; in consideration of her doing so, she received a lump sum of $55,000. The question is whether, with respect to that $55,000, resulting from the frustration of the testator's purpose through the destruction of the trust, she is entitled to the exceptional advantages of the capital gains provisions.

We must, then, ascertain the intention of Congress expressed in those provisions—especially § 117(a)(1)—in the light of the language it employed and the policy there embodied, i.e., we must determine whether Congress intended that a taxpayer who receives income in those circumstances should come within that exception.

My colleagues avoid a direct discussion of that problem. Instead, they rely on *Blair* v. *Commissioner*, 300 U.S. 5, 57 S. Ct. 330, 81 L. Ed. 465, which they hold to be controlling. But the court in the *Blair* case had no occasion to, and did not, consider § 117; it considered solely the interpretation of § 22(a). There, the holder of a life interest, created by a trust, had made a gift for life of a share of the future income. The only question was whether thereafter the donor, notwithstanding the gift, should be regarded, under § 22(a), as the recipient annually of that part of the income which was the subject of the gift and, consequently, should be taxed each year thereon. In other words, no capital gain or loss was involved, and the one issue was whether the donor or donee was annually taxable. The only conceivable ground for holding the donor liable was — as the court recognized in *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655, and *Harrison* v. *Schaffner*, 312 U.S. 579, 61 S. Ct. 759, 85 L. Ed. 1055 — that which moved the Court in *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788, *i. e.*, that, in terms of "non-material satisfactions" the donor had not, by the gift, changed his position and, because of his continued "enjoyment of the economic benefit," [311 U.S. 112, 61 S. Ct. 147] must still be regarded, within § 22(a), as receiving the income actually paid to the donee. In the *Horst* and *Schaffner* cases, the Court said the donor was thus within § 22(a); in the *Blair* case, because the gift transferred the income for the duration of the donor's life, the Court held he was not. In the *Schaffner* case, the Court distinguished the *Blair* case, saying that there was a difference

> between a *gift* of an equitable interest in property for life . . . of a share of the income of the trust and the *gift* of the income or a part of it for the period of a year as in this case.

Since the Court in the *Blair* case was not called on to say (as we are here) whether the taxpayer was liable under either § 22(a) or under § 117, but only whether taxpayer was liable, if at all, under § 22(a), the *Blair* case sheds no light on the construction of § 117. Surely it does not follow merely (1) because one who makes a gift of a life estate does not retain such "non-material satisfactions" as to be liable under § 22(a), that (2) one who disposes of a life estate for a valuable consideration is to be treated as having disposed of a "capital asset" under § 117(a) (1) and is therefore entitled to the peculiar, exceptional, treatment accorded by the capital gains provisions. So, when it was argued that an interest

which, pursuant to the *Horst* case, was "property" for the purposes of § 22(a) must be "capital" for purposes of the capital gains provisions, the Supreme Court answered that " 'property' and 'capital' are not necessarily synonymous in the Revenue Act of 1932 or in common usage"; *Hort* v. *Commissioner*, 313 U.S. 28, 31, 61 S. Ct. 757, 758, 85 L. Ed. 1168.

In interpreting the capital gains provisions, we ought to have in mind that they have a legislative history and embody a legislative policy distinct, respectively, from the history and the policy embodied in § 22(a). As we said recently,

It is well to remember that the concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background.

Rohmer v. *Commissioner*, 2 Cir., 153 F.2d 61, 65. For that reason, I think the language used by the Supreme Court in *Blair*, a gift case under § 22(a), should not be applied here. Such an application, I think, involves the assumption that words, regardless of their context, have a constant meaning.

The policy of the capital gains provisions is not in doubt: Congress believed that the exaction of income tax on the usual basis on gains resulting from dispositions of capital investments would undesirably deter such dispositions. To put it differently, Congress made an exception to § 22(a), in order to give an incentive to the making of such transfers. Having regard to that purpose, the courts have been cautious in interpreting the clauses creating that exception. They have refused to regard as "capital" transactions for that purpose divers sorts of transfers of "property," especially those by which transferors have procured advance payments of future income.[1]

Those cases and *Hort* v. *Commissioner*, 313 U.S. 28, 61 S. Ct. 757, 85 L. Ed 1168, seem to me to render it somewhat doubtful whether any transfer of a life estate for a valuable consideration is within § 117. The consideration paid for such a transfer is a substitute for future payments which would be taxable as ordinary income, and resembles the advance payment of dividends, interest or salaries. I am, therefore, not at all sure that *Bell's Estate* v. *Commissioner*, 8 Cir., 137 F.2d 454, is correct (although, for reasons noted below, I think it is not apposite here). It may well be that, had Congress specifically thought of the problem, it would explicitly so have defined "capital assets" as to exclude such an interest. I do not say that *Hort* v. *Commissioner* conclusively fixes that interpretation, but it does so suggest.

It suggests far more strongly that we cannot reasonably extrapolate the language of § 117 to include the transaction before us in the instant case. In the *Hort* case, the Supreme Court held that the "prepayment of the discounted value of unmatured rental payments" to a landlord on the cancellation of a lease constituted "ordinary income," coming within § 22(a), and not within the capital gains clauses. The Court said, "Simply because the lease was 'property' the amount received for its cancellation was not a return of capital"; and it also said that

it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital". . . . The cancellation of the lease involved

[1] See, *e. g.*, Helvering v. Smith, 2 Cir., 90 F.2d 590, 592; Levinson v. Commissioner, 2 Cir., 154 F.2d 60; Rhodes' Estate v. Commissioner, 6 Cir., 131 F.2d 50, *cf.* Ansorge v. Commissioner, 2 Cir., 147 F.2d 459, 461.

nothing more than the relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises . . .

and it added that § 22(a) "does not distinguish rental payments and a payment which is clearly a substitute for rental payments."

That ruling is indeed suggestive here. For here we have these facts: The creator of the trust did everything he could to keep the taxpayer from disposing of her life interest.[2] Aided by what my colleagues described as "the ingenuity of counsel," she succeeded in frustrating his effort to prevent such alienation, by joining with the other persons interested in the trust to "extinguish" and "cancel" it, the instruments she executed in that connection recited that the payment to her was "to represent the value of her life interest" and that the "settlement is based to a large extent upon her life expectancy." In that way, what the testator intended should be given to her only in instalments, she procured, in effect, in a lump sum payment.

I think it most unlikely that Congress intended by § 117 to relieve such a taxpayer of the ordinary tax burdens, to supply an incentive for the demolition of such a trust. That the life tenant in the *Blair* case in somewhat similar manner avoided the intent of the trust's creator is, I think, of no moment; for that conduct was not relevant to the issue of Congressional purpose there before the Court, *i.e.*, whether § 22(a) made her taxable on the income subsequently paid her donee. But here the question is whether Congress meant that the exceptional benefits of § 117 should be accorded a taxpayer who, in disposing of her life interest, circumvented the avowed purpose of the creator of the trust. I think not.

Perhaps *Bell's Estate* v. *Commissioner*, 8 Cir. 137 F.2d 454, is distinguishable from the instant case. For there the creator of the trust had not sought to prevent alienation of the life interests, and it is arguable that furtherance of sales of such interests falls within the intention of § 117. But, since that question is not present here, I think we should leave it unanswered.

For the foregoing reasons, I think the Tax Court's decision should be affirmed.

Note

Why did the taxpayer have a loss when she received payment of $55,000? For some startling ramifications of transactions with life interests, see Plumb, "Tax Effects of Sales of Life Interests in Trusts: How to Eat Your Cake and Have It," 9 *Tax L. Rev.* 39 (1953).

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[2] His will and codicil contained the following provisions

"I further direct that the income from the various trusts hereinabove created shall not be subject to any transfers, assignments or encumbrances, made or created by any of the respective beneficiaries, and shall not be subject to any suits, liens, judgments, attachments, or executions resulting from any debts or acts of any of the respective beneficiaries, nor shall the same be subject to any suits, actions or proceedings, of any kind, brought against any of them. . . .

"I will and direct that all the shares of principal and income by this my will given to or directed to be held for the use and benefit of the several and respective beneficiaries in the Trusts in this my will mentioned or set out shall not be in any way or manner subject or liable to their or either of their anticipation, sale, pledge, debts, contracts, engagements or liabilities, and not subject or liable to attachment or sequestration under any legal or equitable or other process."

STARR BROTHERS v. COMMISSIONER

Tax Court of the U. S., 1952
18 T.C. 149

ARUNDELL, Judge

The issue in this proceeding is the narrow one of whether the amount of $6,394.57 received by the petitioner in 1943 from United Drug Company was capital gain or ordinary income. The petition makes mention of a March 1, 1913, value, but this was not developed at the trial or on brief, and the parties have presented the case on the theory that the entire amount received was income.

The statute defines as capital assets "property held by the taxpayer" with certain exclusions that are not presently material. Internal Revenue Code section 117(a) (1). Capital gain is the "gain from the sale or exchange of a capital asset. . . ." Code section 117(a)(2) and (a)(4).

In view of the provisions of the Code, upon which both parties rely, there are two matters that require resolution before we can arrive at the ultimate answer in this proceeding. The first is whether the 1903 agreement was property in the hands of the petitioner. Second, if it was property, whether there was a sale of it. If both are resolved affirmatively, the petitioner makes its case under the applicable Code provisions If either is resolved in the negative, the respondent's determination must stand.

The starting point is the agreement of November 17, 1903, between the petitioner and United Drug Company. That agreement nominated the petitioner to be United Drug Company's special selling agent in New London, Connecticut, for as long as the petitioner should perform the terms of the agreement. The petitioner, on its part, agreed to uphold all of the products of United Drug Company to the full list retail prices set by that company. In short, the agreement was one whereby the petitioner became United Drug Company's exclusive retail outlet in the city of New London, without a time limitation. Neither party questions the validity of this contract. While contracts are property, the decisions are to the effect that not all property rights constitute capital assets. Whether or not they are depends, at least in part, upon the nature of the income that would normally result from the fulfilment of the terms of the contract. If it is one that provides for the rendition of personal services, its sale, commutation, or extinguishment by agreement between employer and employee does not change the inherent character of the income realized under it. *Thurlow E. McFall*, 34 B.T.A. 108, *George K. Gann*, 41 B.T.A. 388. Even though there is no strict employer-employee relation, if the contract requires the rendition of personal services, the proceeds of its sale are ordinary income. *General Artists Corporation*, 17 T.C. 1517. Again, if it provides for payment of rent, a lump sum payment in commutation does not change the character of the income that is realized. *Hort* v. *Commissioner*, 313 U.S. 28. Proceeds from the sale of the right to insurance commissions are ordinary income "since there was no capital asset to dispose of." *Estate of Thomas F. Remington*, 9 T.C. 99. In the *Hort* case, *supra*, a lessee of real estate under a long term lease paid a lump sum to effect a cancellation of the lease. The lessor claimed that the lump sum payment, if income at all, was taxable under the gain or loss provisions of the Revenue Act of 1932

as a capital gain. The Supreme Court, in holding that the payment was ordinary income, said:

> Where, as in this case, the disputed amount was essentially a substitute for rental payments which § 22 (a) expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital."

On the other hand, an agency contract, even though services may be required in order to make it lucrative, is regarded as property that is a capital asset, and a payment by the principal for its termination is capital gain. *Jones* v. *Corbyn*, 186 F.2d 450. In that case, the taxpayers were members of a partnership which, by contract, was the exclusive agency of a life insurance company in a designated territory. In 1944, the company and the agency entered into a written contract which terminated the partnership's agency contract, and provided that the partnership should turn over to the insurance company its office space, and records and files pertaining to the company business. The insurance company paid the agency the sum of $46,500, of which $1,500 represented fees to be paid by the agency to attorneys representing it in litigation then pending between the company and the agency. The court held that the $45,000 received by the agency constituted capital gain. On the point of whether the agency contract was a capital asset, the court said in part:

> The contract or franchise had at all times substantial value. It was capable of producing income for its owner. It was enforceable at law and could be bought and sold. Acting under its provisions, the agents developed a large and lucrative business. . . . Except for the renewal commissions, the effect of the termination contract was to transfer the business to the company intact.
>
> The statutory definition of capital assets includes all property not excluded. Mertens *Law of Federal Income Taxation*, Vol. 3, Sec. 22.04. If the thing given up by the taxpayers is property within the meaning of the statute, then, of course, it is a capital asset. The term "capital assets" should not be considered in a technical or restricted sense but should be given its ordinary meaning.

In holding that the transaction between the insurance company and the agency was a sale, the court said:

> Broadly speaking, a sale is a transfer of property for a valuable consideration. . . . [cases]. By terminating the contract and transferring the business to the company, there was a sale and transfer of a capital asset within the meaning of the statute. . . . The amount of the settlement in this case was not based upon damages. It was based upon the value of the exclusive business franchise.

In the case of *Elliott B. Smoak*, 43 B.T.A. 907, the taxpayer had an exclusive agency for leasing and licensing machinery. He sold all of his interest in the agency contract for a sum paid in cash and a further sum to be paid over a period of years. In holding the income realized to be capital gain, we said that "What the petitioner sold was an agency business" and that "it was a capital asset."

We are of the opinion that the facts in the present case bring it within the scope of the holdings in *Jones* v. *Corbyn*, and *Elliott B. Smoak*, *supra*. The exclusive agency owned by the petitioner constituted property in its hands, and it sold that property in the taxable year. The agency contract did not require it to render personal services, though to be sure the petitioner expected to perform

selling services in order to assure itself of income. But there was no employer-employee relationship between it and the grantor of the license. There was nothing in the nature of commissions or rentals to be paid by the grantor, as in the *Remington* and *Hort* cases, *supra.*

The respondent's principal argument is that the transaction between the petitioner and United Drug Company was not a sale but was essentially an extinguishment of the petitioner's exclusive agency. This argument is answered by the case of *Isadore Golonsky*, 16 T.C. 1450,* where the owner of real estate paid a lump sum to the lessees for an accelerated termination of the lease. The lessees were before us in that case and we held that the income realized by them in the lump sum payment was capital gain. In so holding, we pointed out that the lessees "had a right under the lease to possession and use of the property" and that the sum paid by the owner was "to acquire the right to the use and possession of the property" for the remainder of the lessees' term, and concluded that "That is a sufficient transfer of property to bring the transaction within section 117." We said, in part:

> The use of the word "cancellation" is not determinative where something is transferred. *Cf. Jones* v. *Corbyn*, 186 F.2d 450. The case is unlike *Hale* v. *Helvering*, 85 F. 2d 819, involving the satisfaction of a debt in which no property was received by the debtor.

Similarly, in *McAllister* v. *Commissioner*, 157 F.2d 235, where the life tenant sold her interest to the remainderman under an instrument which provided that her interest should be "terminated," the court held that the choice of words was not determinative of what had actually occurred, and treated the transaction as the sale of a capital asset by the life tenant.

On authority of the above cases, we hold that the exclusive license held by the petitioner under the 1903 agreement was a capital asset which it sold to United Drug Company in 1943, and that the income realized was capital gain.

Reviewed by the Court.

Decision will be entered under Rule 50.

LEMIRE, J., concurring:

I think that this case involves the same question we had before us in *General Artists Corporation*, 17 T.C. 1517. The distinction of the present case on the grounds that the assigned contract here does not require the "rendition of personal services" is, I believe, unwarranted. Accordingly, I concur in the result reached in the instant case, but wholly on the basis of my dissenting opinion in the *General Artists Corporation* case.

Note

1. The Tax Court's decision was reversed by the Court of Appeals, Second Circuit, 204 F.2d 673 (1953), on the ground that there was no "sale or exchange":

> What the taxpayer gave in return for the cash payment was a release of United's contract obligations, chief of which was its promise not to sell its products to other dealers in New London. Such release not only ended promisor's previously existing duty but also destroyed the promisee's rights. They were not transferred to the promisor, they merely came to an end and vanished.

* Affirmed, Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), cert. den. 345 U.S. 939 (1953). [Ed.]

The Court went on to express its disagreement with the Tenth Circuit's holding in *Jones* v. *Corbyn* that the cancellation of an insurance agency contract was a "sale," as well as to shed some doubt on the validity of its own decision in the *McAllister* case:

> That case was decided upon the theory that it was within the rule of *Blair* v. *Commissioner*, 300 U.S. 5, rather than that of *Hort* v. *Commissioner*, 313 U S. 28. Whether that distinction is valid we need not now consider. In any event, to hold the life tenant's transfer a "sale" puts less strain upon the ordinary meaning of that term than does a holding that the taxpayer's release of United's negative covenant is a sale.

As to whether the contract with United Drug Company was a "capital asset"—an important issue since the rights under such a contract might be "sold" to a third party if capital gain could thereby be obtained—the Second Circuit only said that it would assume "arguendo" that it was.

Not long after the *Starr Bros., Inc.* case was decided by the Court of Appeals, Second Circuit, on the theory that there was no sale, it had to say whether an amount paid by a landlord to a tenant for vacating premises which it was entitled to occupy as a statutory tenant under state rent controls was the proceeds of a "sale or exchange" of a capital asset. It said:

> In [the *Starr Bros., Inc.* case] no "sale or exchange" within the meaning of the statute was found because the contractual right was not transferred, but was released and merely vanished. However, we think the right of possession under a lease or otherwise, is a more substantial property right which does not lose its existence when it is transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain, *Sutliff* v. *Commissioner*, 46 B.T.A., and we see no reason why a different result should be reached here. *Commissioner* v. *McCue Bros. & Drummond, Inc.*, 210 F.2d 752 (2nd Cir. 1954).

See also the *Golonsky* case, *supra*, p. 433. In *Commissioner* v. *Ray*, 210 F.2d 390 (5th Cir. 1954), capital gain treatment was extended to a payment received by a tenant for releasing his landlord from a restriction in a five-year lease that prohibited renting certain adjacent property to a competitive variety store.

Section 1241 of the 1954 Code provides a statutory guide to certain aspects of these problems. Does it insure capital gain or loss treatment for the amounts in question, or does it simply get the taxpayer over the "sale or exchange" hurdle, leaving him to establish independently that the lease or distributor's agreement is a "capital asset" Would § 1231, so far as it relates to depreciable property used in the trade or business, have any application here? Note that a distributor must have a "substantial capital investment in the distributorship." What does this mean? Would the Starr Brothers' stock of United Drug Co. products qualify? Must the investment be "substantial" in relation to the amount received by the taxpayer? Why are only distributors of goods, and not other agents and holders of franchises, included in the statute? The Senate Report states (p. 115) that "the section is limited in scope and it does not constitute a reexamination of present law relating to contracts to which the section does not specifically apply." Note that as to leases, § 1241 applies to payments received by the lessee, but not to those received by the lessor, and that only amounts "for the cancellation" of a lease qualify.

The *McFall* case, cited and distinguished by the Tax Court in the principal case, involved two taxpayers who had been employed under five year contracts for a fixed salary and a percentage of the employer's profits. When the contracts had two and a half years to run, they agreed to "sell" them to a third party (who wanted the contracts terminated to facilitate a refinancing of the employer) for $175,000 each. The Board of Tax Appeals, holding that the proceeds constituted ordinary income rather than capital gain, said:

> Petitioners did not sell their contracts, for inherently this they could not do . . . Before they had any contractual rights which they could sell, they were obligated to perform services for the company. . . . On April 2, 1929 [the date they agreed to

> sell the contracts], there was a right of petitioners to continue to perform services and then to be paid—to persist in their contractual relation for its agreed term. While this right is property in the constitutional sense in that it could not be arbitrarily legislated away, it is not capital. . . . Obviously it is not the sort of property which is susceptible of ownership for a length of time as is a share of stock, a bond, or a thing. (34 B.T.A. 108, 110.)

Is this reasoning applicable to the exclusive agency of Starr Brothers, Inc., at least if it was not assignable without the consent of the United Drug Company?

2. What became of the Tax Court's view that whether a contract is a capital asset "depends, at least in part, upon the nature of the income that would normally result from the fulfillment of the contract?" If the taxpayer in the principal case had continued in business as United Drug's exclusive agent, ordinary income would have been realized.

3. Capital gain treatment has been granted to income received on the sale of good will, even though created by personal service and skill. *Michaels* v. *Commissioner*, 12 T.C. 17 (1949). (As pointed out *infra*, p. 276, good will has generally been regarded as non-depreciable, and it is consequently not taken out of the capital asset category by § 1221(2).) Indeed, in the *Michaels* case, the taxpayer was accorded capital gain on a lump sum received for the good will of a business that he conducted as an individual proprietorship and for his personal covenant not to compete, although amounts received for the latter are customarily taxed as ordinary income. The Court said that where

> it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred . . .
>
> We have accordingly found as a fact, though the matter is not free from doubt, that the agreement to refrain from competition should be treated as a capital asset ancillary to the transfer of good will and customers. (12 T.C. at 19–20.)

The sale of the stock of a corporation is often accompanied by an agreement not to compete. *Hamlin* v. *Commissioner*, 209 F.2d 761 (10th Cir. 1954), involved a sale of stock with a covenant by the stockholders not to compete for a period of ten years. After a draft contract was prepared under which the seller was to pay $1,000,000 for the stock with no stated amount for the covenant, the buyer suggested a change by which $750,000 would be allocated to the stock and $250,000 to the covenant:

> He stated in substance that the purpose of the suggested provision was to make such provision for non-competition enforceable and to help him and his associates taxwise. With very little discussion, the stockholders present agreed to the suggested provision, because they thought it would make no difference to them. (209 F.2d at 763.)

The court held that the covenant was not ancillary to a sale (as in the *Michaels* case, *supra*) because the sellers sold stock and not a going business; and it also held that the sellers were bound by their own allocation despite the circumstances under which they agreed to it. Consequently the amount received for the covenant was ordinary income, and the amount received for the stock gave rise to capital gain or loss. In *Gazette Telegraph Co.*, 19 T.C. 692, 696 (1953), the same allocation was accepted in computing the buyer's amortization of the covenant. There it was stated that the buyers

> insisted upon a fixed and separate consideration for the covenant not to compete in order to establish its value and also for the purpose of fixing liquidated damages to be paid in the event of its breach.

See Taylor, "Covenants Not to Compete Consulting Arrangements, Adjustments to Purchase Price," *12th Annual N.Y.U. Inst. on Fed. Taxation* 1047 (1954). See also Paul, "The Lawyer As a Tax Adviser," 25 *Rocky Mt. L. Rev.* 412, 421:

> It is easy to give illustration of prevailing techniques of misrepresentation. One

favorite device is to put a transaction into two contracts, one of which is to be shown to the Government's representatives, and the other of which is to be kept secret. This happened once in my experience in connection with a sale of stock to a buyer for about $5 million. Since the buyer had an option on the stock of about $3 million, it was obvious that $2 million was being paid for an agreement not to compete. A payment for this covenant would have been ordinary income and not capital gain. The seller insisted that this transaction be put in two documents, one which would recite the sale of stock for $5 million, and the other of which would provide against competition without mentioning any consideration. I felt obliged to refuse to be an adviser in this transaction. As a result, my client, who had reluctantly agreed because of anxiety to procure the stock, went to another attorney who was willing to let the client do what the seller wished. The client never came to me with his subsequent problems.

4. Note the quotation from the *Hort* case, where a lessee's payment of $140,000 to his lessor to obtain a cancellation of a burdensome lease was held to be ordinary income and not capital gain. Presumably if the lessor had sold the property, subject to the lease, to a third party, he would have realized capital gain. What if the property were worth nothing apart from the lease, so that on its sale the lessor received just $140,000, *i.e.*, the amount the buyer assumed he could extract from the lessee for a cancellation? What if the lessor sold the property to the lessee, receiving an amount equal to the value of the property free of a lease plus $140,000? In point of fact, does not the value of any real estate (or other property) represent simply the discounted value of the income it will produce in the future?

5. Section 421, enacted in 1950, grants capital gain treatment to the employee who is compensated with a "restricted stock option." To what extent does it turn profit that would otherwise be ordinary income into capital gain? Lyon, "Employee Stock Options Under the Revenue Act of 1950," 51 *Col. L. Rev.* 1 (1951). The section was changed in certain respects in 1954.

6. Time Magazine (May 18, 1953) contained this report on the recent financial success of the Ford Motor Company:

> The management team that put the whole works in the black is getting rewards commensurate with its achievement. To get the new men the Ford company wanted —and to keep valuable old hands from being lured away—the Ford brothers let the top brass write out their own incentive plan. A new company, Dearborn Motors, Inc. was set up by the executives as the selling agent for tractors, and the stock was split among Breech, former Sales Manager Jack Davis, Production Boss Del Harder, Labor Boss John Bugas, Ford Division Boss Crusoe and eight others.
>
> The Ford company will soon buy up the stock of Dearborn Motors at a price which will give the holders huge capital gains . . .

WILLIAMS v. McGOWAN

U. S. Court of Appeals, Second Circuit, 1945
152 F.2d 570

Before: L. Hand, Swan and Frank, Circuit Judges.

L. Hand, Circuit Judge.

This is an appeal from a judgment dismissing the complaint in an action by a taxpayer to recover income taxes paid for the year 1940. . . .

Williams, the taxpayer, and one Reynolds, had for many years been engaged in the hardware business in the City of Corning, New York. On the 20th of January, 1926, they formed a partnership, of which Williams was entitled to two-thirds of

the profits, and Reynolds, one-third. They agreed that on February 1, 1925, the capital invested in the business had been $118,082.05, of which Reynolds had a credit of $29,029.03, and Williams, the balance—$89,053.02. At the end of every business year, on February 1st, Reynolds was to pay to Williams, interest upon the amount of the difference between his share of the capital and one-third of the total as shown by the inventory; and upon withdrawal of one party the other was to have the privilege of buying the other's interest as it appeared on the books. The business was carried on through the firm's fiscal year, ending January 31, 1940, in accordance with this agreement, and thereafter until Reynold's death on July 18th of that year. Williams settled with Reynolds's executrix on September 6th in an agreement by which he promised to pay her $12,187.90, and to assume all liabilities of the business; and he did pay her $2,187.98 in cash at once, and $10,000 on the 10th of the following October. On September 17th of the same year, Williams sold the business as a whole to the Corning Building Company for $63,926.28—its agreed value as of February 1, 1940—"plus an amount to be computed by multiplying the gross sales of the business from the first day of February, 1940 to the 28th day of September, 1940," by an agreed fraction. This value was made up of cash of about $8100, receivables of about $7000, fixtures of about $800, and a merchandise inventory of about $49,000, less some $1000 for bills payable. To this was added about $6000 credited to Williams for profits under the language just quoted, making a total of nearly $70,000. Upon this sale Williams suffered a loss upon his original two-thirds of the business, but he made a small gain upon the one-third which he had bought from Reynolds's executrix; and in his income tax return he entered both as items of "ordinary income," and not as transactions in "capital assets." This the Commissioner disallowed and recomputed the tax accordingly, Williams paid the deficiency, and sued to recover it in this action. The only question is whether the business was "capital assets" under § 117(a)(1) [§ 1221(1), 1954 Code].

It has been held that a partner's interest in a going firm is for tax purposes to be regarded as a "capital asset." *Stilgenbauer* v. *United States*, 115 F.2d 283 (CCA 9); *Commissioner* v. *Shapiro*, 125 F.2d 532 (CCA 6). We too accepted the doctrine in *McClellan* v. *Commissioner*, 117 F.2d 988, although we had held the opposite in *Helvering* v. *Smith*, 90 F.2d 590, where the partnership articles had provided that a retiring partner should receive as his share only his percentage of the sums "actually collected" and "of all earnings . . . for services performed." Such a payment, we thought, was income; and we expressly repudiated the notion that the Uniform Partnership Act had, generally speaking, changed the firm into a juristic entity. See also *Doyle* v. *Commissioner*, 102 F.2d 86 (CCA 4). If a partner's interest in a going firm is "capital assets" perhaps a dead partner's interest is the same. New York Partnership Law §§ 61, 62(4). We need not say. When Williams bought out Reynolds's interest, he became the sole owner of the business, the firm had ended upon any theory, and the situation for tax purposes was no other than if Reynolds had never been a partner at all, except that to the extent of one-third of the "amount realized" on Williams's sale to the Corning Company, his "basis" was different. The judge thought that, because upon that sale both parties fixed the price at the liquidation value of the business while Reynolds was alive, "plus" its estimated earnings thereafter, it was as though Williams had sold his interest in the

firm during its existence. But the method by which the parties agreed upon the price was irrelevant to the computation of Williams's income. The Treasury, if that served its interest, need not heed any fiction which the parties found it convenient to adopt; nor need Williams do the same in his dealings with the Treasury. We have to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in § 117(a)(1), or whether the whole business is to be treated as if it were a single piece of property.

Our law has been sparing in the creation of juristic entities; it has never, for example, taken over the Roman "universitas facti" [1] and indeed for many years it fumbled uncertainly with the concept of a corporation. [2] One might have supposed that partnership would have been an especially promising field in which to raise up an entity, particularly since merchants have always kept their accounts upon that basis. Yet there too our law resisted at the price of great and continuing confusion; and, even when it might be thought that a statute admitted, if it did not demand, recognition of the firm as an entity, the old concepts prevailed. *Francis* v. *McNeal*, 228 U.S. 695. And so, even though we might agree that under the influence of the Uniform Partnership Act a partner's interest in the firm should be treated as indivisible, and for that reason a "capital asset" within § 117(a)(1), we should be chary about extending further so exotic a jural concept. Be that as it may, in this instance the section itself furnishes the answer. It starts in the broadest way by declaring that all "property" is "capital assets," and then makes three exceptions. The first is "stock in trade... or other property of a kind which would properly be included in the inventory"; next comes "property held . . . primarily for sale to customers"; and finally, property "used in the trade or business of a character which is subject to . . . allowance for appreciation." In the face of this language, although it may be true that a "stock in trade," taken by itself, should be treated as a "universitas facti," by no possibility can a whole business be so treated; and the same is true as to any property within the other exceptions. Congress plainly did mean to comminute the elements of a business; plainly it did not regard the whole as "capital assets."

As has already appeared, Williams transferred to the Corning Company "cash," "receivables," "fixtures," and a "merchandise inventory." "Fixtures" are not capital because they are subject to a depreciation allowance; the inventory, as we have just seen, is expressly excluded. So far as appears, no allowance was made for "good-will"; but, even if there had been, we held in *Haberle Crystal Springs Brewing Company* v. *Clarke, Collector*, 30 F.2d 219, that "good-will" was a depreciable intangible. It is true that the Supreme Court reversed that judgment—280 U.S. 384 —but it based its decision only upon the fact that there could be no allowance for the depreciation of "good-will" in a brewery, a business condemned by the Eighteenth Amendment. There can of course be no gain or loss in the transfer of cash; and, although Williams does appear to have made a gain of $1072.71 upon the "receivables," the point has not been argued that they are not subject to a

[1] "By universitas facti is meant a number of things of the same kind which are regarded as a whole; *e.g.* a herd, a stock of wares." Mackeldey, *Roman Law* § 162.

[2] "To the 'church' modern law owes its conception of a juristic person, and the clear line that it draws between 'the corporation aggregate' and the sum of its members." Pollock & Maitland, Vol. 1, p. 489.

depreciation allowance. That we leave open for decision by the district court, if the parties cannot agree. The gain or loss upon every other item should be computed as an item in ordinary income.

Judgment reversed.

FRANK, Circuit Judge, *dissenting* in part:

I agree that it is irrelevant that the business was once owned by a partnership. For when the sale to the Corning Company occurred, the partnership was dead, had become merely a memory, a ghost. To say that the sale was of the partnership's assets would, then, be to indulge in animism.

But I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company, actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern. Here is what they said in their agreement:

> The party of the first part agrees to sell and the party of the second part agrees to buy, *all of the right, title and interest* of the said party of the first part *in and to the hardware business* now being conducted by the said party of the first part, *including* cash on hand and on deposit in the First National Bank & Trust Company of Corning in the A. F. Williams Hardware Store account, in accounts receivable, bills receivable, notes receivable, merchandise and fixtures, including two G. M. trucks, good will and all other assets of every kind and description used in and about said business.[3] . . . Said party of the first part agrees not to engage in the hardware business within a radius of twenty-five miles from the City of Corning, New York, for a period of ten years from the 1st day of October 1940.

To carve up this transaction into distinct sales—of cash, receivables, fixtures, trucks, merchandise, and good will—is to do violence to the realities. I do not think Congress intended any such artificial result. In the Senate Committee Report on the 1942 amendment to § 117, it was said: "It is believed that this Senate amendment will be of material benefit to business which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss. The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than six months which it not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section." These remarks show that what Congress contemplated was not the sale of a going business but of its dismembered parts. Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspects of the matter should guide our guess as to what Congress meant. I believe Congress had those aspects in mind and was not thinking of the nice

[3] Emphasis added.

distinctions between Roman and Anglo-American legal theories about legal entities.

Note

1. The effect of this decision, which was cited with approval by the Supreme Court in *Watson* v. *Commissioner*, 345 U.S. 544, is that gain or loss must be separately reckoned on each item, to ascertain both the amount of gain or loss on that item and whether it is capital or ordinary. Consequently, if there is a sale for a lump sum that amount must be allocated to the various items, and if the parties did not do so, or made an artificial allocation, the Commissioner and courts must do it for them. See, for an example, *Cohen* v. *Kelm*, 119 F. Supp. 376 (D. Minn. 1953). See also *Michaels* v. *Commissioner*, *supra*, p. 435.

Assuming that the buyer and seller, having agreed on a lump-sum sales price, are about to make their own allocation of it to the various assets, will their interests coincide, *i.e.*, will the buyer want a high-cost basis for the same assets for which the seller wants a high sales price?

The approach of *Williams* v. *McGowan* is not restricted to the sale of an individual proprietorship, a similar allocation would be required if a partnership or a corporation sold its business as a going concern. In the case of a partnership it would be necessary to decide whether each partner sold his partnership interest or the group sold the entire business. See *Hatch's Estate* v. *Commissioner*, 198 F.2d 26 (9th Cir. 1952), where the court, although apparently holding contrary to *Williams* v. *McGowan* that an entire business is a capital asset, acknowledged that a sale of the firm's assets as such would be taxed differently from a sale of the partners' interests. See also *Kaiser* v. *Glenn*, 114 F. Supp. 356 (W.D. Ky. 1953).

Should the tax results hinge on whether the sale is regarded as a sale of (a) the assets of the partnership, (b) the going business of the partnership, or (c) the interests of the partners? See Note, Some Tax Consequences of Partnership Readjustments, 67 *Harv. L. Rev.* 860 (1954).

The sale of an interest in a partnership is now governed by statute, Ch. 7, Sec. B, but there is still no explicit statutory provision dealing with the sale by a partnership of its business as a going concern.

2. How should gain or loss on the accounts receivable be taxed? See § 1221(4), rejecting the position taken in *Graham Mill & Elevator Co.* v. *Thomas*, 152 F.2d 564; *Torodor* v. *Commissioner*, 19 T.C. 530 (1952). If the purchaser of the accounts collects more or less than he paid for them, or if he sells them, how will his gain or loss be taxed?

MERCHANTS NAT'L BANK v. COMMISSIONER

U. S. Court of Appeals, Fifth Circuit, 1952
199 F.2d 657

Before BORAH, STRUM, and RIVES, Circuit Judges.

STRUM, Circuit Judge.

This is a petition to review a decision of the Tax Court which sustained deficiency assessments in petitioner's income taxes for the years 1943 and 1944.

The 1944 deficiency arose from the following facts: On January 1, 1941, the petitioner held notes of Alabama Naval Stores Company, representing loans made by the bank to the Naval Stores Company, on which there was an unpaid balance of $49,025.00. In 1941 and 1943, at the direction of national bank examiners, the bank charged these notes off as worthless, thereafter holding them on a "zero" basis. Deductions for the charge-offs, as ordinary losses, were allowed

in full by the Commissioner on petitioner's income tax returns in 1941 and 1943. In 1944, petitioner sold the notes to a third party for $18,460.58, which it reported on its return for 1944 as a long term capital gain and paid its tax on that basis. The Commissioner held this sum to be ordinary income, taxable at a higher rate than long term capital gains, and entered a deficiency assessment accordingly, in which he was sustained by the Tax Court. This is the basis of the 1944 controversy.

The rule is well settled, and this Court has held, that when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year. *Commissioner* v. *First State Bank of Stratford*, 5 Cir., 168 F.2d 1004, 7 A.L.R.2d 738, certiorari denied 335 U.S. 867, 69 S. Ct. 137, 93 L. Ed. 412; *Nat'l Bank of Commerce of Seattle* v. *Commissioner of Internal Revenue*, 9 Cir., 115 F.2d 875.

When these notes were charged off as a bad debt in the first instance, the bank deducted the amount thereof from its ordinary income, thus escaping taxation on that portion of its income in those years. The amount subsequently recovered on the notes restores *pro tanto* the amount originally deducted from ordinary income, and is accordingly taxable as ordinary income, not as a capital gain. When the notes were charged off, and the bank recouped itself for the capital loss by deducting the amount thereof from its current income, the notes were no longer capital assets for income tax purposes. To permit the bank to reduce its ordinary income by the amount of the loss in the first instance, thus gaining a maximum tax advantage on that basis, and then permit it to treat the amount later recovered on the notes as a capital gain, taxable on a much lower basis than ordinary income, would afford the bank a tax advantage on the transaction not contemplated by the income tax laws.

The fact that the bank sold these notes to a third party, instead of collecting the amount in question from the maker of the notes does not avoid the effect of the rule above stated. Nor are the cases just cited distinguishable, as contended by appellant, because in the first the notes were distributed as a dividend in kind, and in the second were received by the taxpayer as part of a non-taxable reorganization. The controlling point in both cases is, as here, that the amount of the notes was originally deducted from ordinary income, and the owner-bank allowed a tax benefit on that basis, from which premise both courts concluded that the taxpayer should settle on the same basis as to sums subsequently recovered, since those sums stand in place of the income which escaped taxation in the year when the deduction was taken.

As the recoveries in question were ordinary income, not capital gains, the 1944 deficiency was properly entered.

Affirmed.

Note

1. Note the court's reference to "a tax advantage not contemplated by the income tax laws." What if, by reason of changing tax rates or the taxpayer's fluctuating income, ordinary income in 1944 on proceeds of a sale would produce a tax greater than the tax that was saved by the 1941 and 1943 deductions? If a taxpayer deducts a non-business bad debt as a capital loss under § 166(d), can he treat a later recovery on it as capital gain rather than ordinary income even though he has not engaged in a sale or exchange? A taxpayer sold certain real property, reporting a capital gain on the transac-

tion. Several years later the vendees discovered that the building encroached on the land of a third party and paid some $3,000 to relocate the building. The taxpayer, who had sold the property by warranty deed, reimbursed the vendees for this expense and sought to deduct it as an ordinary loss. The Tax Court held that only a capital loss could be taken, since the "adjustment under the warranty was a part and parcel of the sale of the property," on which capital gain rather than ordinary income was realized. *Estate of Shannonhouse* v. *Commissioner*, 21 T.C. 422 (1954).

2. Partly depreciated business property has always been regarded as eligible under § 1231 for capital gain treatment, even though the profit on the sale is a recoupment of depreciation that was deducted from ordinary income. Does the court cast doubt on this assumption? Does it suggest that fully depreciated business property will not qualify under § 1231?

3. Note Section 1239, which deals with another aspect of the interplay between capital gain and ordinary income. It will prevent certain transactions designed to obtain, at the capital gain rate, a stepped-up basis for depreciable property. In its absence a husband might be able to sell appreciated rental property to his wife or to a family corporation, reporting the profit as a long-term capital gain under § 1231, and thus at a low tax cost provide the transferee with a stepped-up basis to be recouped by depreciation deductions from ordinary income.

COMMISSIONER v. CARTER

U. S. Court of Appeals, Second Circuit, 1948
170 F.2d 911

Before L. HAND, SWAN and CHASE, Circuit Judges.

SWAN, Circuit Judge:

This appeal presents the question whether income received by the taxpayer in 1943 is taxable as long-term capital gain, as the Tax Court ruled, or as ordinary income as the Commissioner contends. The facts are not in dispute. The taxpayer, Mrs. Carter, had owned for ten years all the stock of a corporation which was dissolved on December 31, 1942. Upon its dissolution all of its assets were distributed to her in kind, subject to all its liabilities which she assumed. In the distribution she received property having a fair market value exceeding by about $20,000 the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid the tax thereon. In the corporate liquidation she also received 32 oil brokerage contracts which the parties stipulated had no ascertainable fair market value when distributed. Each contract provided for payment to the corporation of commissions on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the corporation or its distributee, and the future commissions were conditioned on contingencies which made uncertain the amount and time of payment. In 1943 the taxpayer collected commissions of $34,992.20 under these contracts. She reported this sum as a long-term capital gain; the Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain. The correctness of this decision is the sole question presented by the Commissioner's appeal.

Mrs. Carter's stock was a "capital asset" as defined by § 117(a) of the Internal Revenue Code. In exchange for her stock, she received the assets of the corporation upon its dissolution. The tax consequences of such a transaction are controlled by § 115(c) which provides that "the gain or loss to the distributee resulting from such exchange" shall be determined under section 111 but recognized only to the extent provided in section 112. Turning to section 111(a). the "gain from the sale

or other disposition of property" is the excess of "the amount realized therefrom" over the adjusted cost basis provided in § 113(b). Paragraph (b) of § 111 defines the "amount realized from the sale or other disposition of property" to be the sum of money received "plus the fair market value of the property (other than money) received." Paragraph (c) of the same section provides that "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112." That section lays down the general rule, subject to exceptions not pertinent to the case at bar, that "upon the sale or exchange of property" the entire amount of the gain or loss, determined under section 111, shall be recognized. From the foregoing statutory provisions,* it is obvious that if the oil brokerage contracts distributed to the taxpayer had then had a "fair market value," such value would have increased correspondingly the "amount realized" by her in exchange for her stock and would have been taxable as long-term capital gain, not as ordinary income. *Boudreau* v. *Commissioner*, 5 Cir., 134 F.2d 360, *Fleming* v. *Commissioner*, 5 Cir., 153 F.2d 361. The question presented by the present appeal is whether a different result is required when contract obligations having no ascertainable fair market value are distributed in liquidation of a corporation and collections thereunder are made by the distributee in later years.

In answering this question in the negative, the Tax Court relied primarily upon *Burnet* v. *Logan*, 283 U.S. 404. That involved a sale of stock, not a distribution in liquidation, under which the seller received cash and the buyer's promise to make future payments conditioned on contingencies. The cash received did not equal the seller's cost basis for the stock, and the contingencies affecting future payments precluded ascribing a fair market value to the buyer's promise. In later years payments were made which the seller did not return as income. The decision held that she was not required to do so With respect to such payments, the court said, pages 412-413:

> As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. . . . When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. . . . She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

The Commissioner argues that the *Logan* case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale, thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in *Commissioner* v. *Hopkinson*, 126 F.2d 406, 410, "payments received by the seller after his basis had been extinguished would have been

* The statutory provisions governing complete liquidations have been somewhat modified by the 1954 Code, Ch 6, Sec. F (1), but not in respects material to this case. [Ed.]

taxable to him as capital gains from the sale of the property," citing *Burnet* v. *Logan* as authority.

The Commissioner also urges that the *Logan* case is distinguishable because it dealt with a sale of stock rather than exchange of stock for assets distributed in a corporate liquidation. This contention is answered by *White* v. *United States*, 305 U.S. 281, 288, and *Helvering* v. *Chester N. Weaver Co.*, 305 U.S. 293, 295, where the court held that the recognition required by § 115(c) of gains and losses on liquidations must for purposes of computation of the tax, be taken to be the same as that accorded to gains and losses on sales of property. Consequently we agree with the Tax Court's ruling that the principle of the *Logan* case is applicable to a corporate liquidation where stock is exchanged in part for contracts having no ascertainable market value, and that future collections under such contracts are taxable as capital gain in the year when received if the distributee has previously recovered the cost basis for the stock.

The Commissioner's argument that such collections are analogous to the receipt of interest or rent upon bonds or real estate distributed in a corporate liquidation overlooks a significant distinction. Payment of interest or rent does not impair the value of the bond or real estate since each remains as a capital asset regardless of the number of payments. See *Helvering* v. *Manhattan Life Ins. Co.*, 2 Cir., 71 F.2d 292, 293. But with respect to the oil brokerage contracts, under which no additional services were to be rendered by the payee, each payment decreases their value until, with the final payment it will be completely exhausted; and, if the payments be treated as income, the distributee has no way to recoup his capital investment, since concededly he has no economic interest in the oil producing properties and therefore no right to depletion deductions. Hence to consider the brokerage payments as ordinary income would produce a most unjust result and one quite unlike the result which follows the distribution of bonds or real estate in a corporate liquidation.

For the foregoing reasons we think the decision of the Tax Court correct. It is affirmed.

Section G. The Holding Period

Note: Sections 1222(1)-(4) and 1223 of the 1954 Code, relating to the holding period of capital assets, carry over the basic principle, with some modifications of detail, of §§ 117(a)(2)-(5) and 117(h) of the 1939 Code.

See Regs. 118, Sec. 39.117(h)-1.

If a taxpayer is approached by a potential buyer during the six-month period, he can of course postpone any transaction until he has held his property for more than six months, even though his only reason for waiting is to secure the benefit of a long-term capital gain. But what if during the period he enters into a contract to sell, with transfer of title to be postponed? If he puts the property into escrow, with delivery to be made by the escrow agent after the period has expired? If he requires the buyer to post a bond or to deposit the price in escrow during the six-month period? If he sells on conditional sale? See *Dyke* v. *Commissioner*, 6 T.C. 1134 (1946); *Watson* v. *Commissioner*, ¶ 49,089 P-H Memo TC; Dibble, "Current Problems in Determining Holding

Period," 1951 *So. Calif. Tax Inst.* 359, see also *Kuehner* v. *Commissioner*,—F.2d— (1st Cir. 1954).

Section 1233(b), derived from a provision added in 1950, was designed to take the profit out of several practices previously employed to outwit the holding period. Example (1) of Regs. 118, Sec. 39.117(l)-1, illustrates the problem. Note that on July 1 the taxpayer has an unrealized profit of $600, which would constitute a short-term gain if realized at that time. By selling short on July 1 he immunizes himself against any subsequent fluctuations of the market, since any increase in the value of the stock resulting in further unrealized appreciation on his "long" position (the stock bought in February) will be counterbalanced by an equal unrealized loss on his "short" position. Conversely, a decline in the value of the stock will improve his "short" position at the expense of his "long" position. Since the taxpayer is thus no longer at the risk of the market after July 1, § 117(l) treats his profit as short-term (February 1-July 1), no matter when he closes out his investments. Before § 1233(b) was enacted, the taxpayer would have claimed a long-term capital gain of $600 on the theory that he sold his February stock on August 2, when he delivered it to satisfy his short position.

Other applications of § 1233(b) may be studied in the examples given in the Regulations. Some of the transactions against which § 1233(b) was aimed are comprehensible only if one recalls that before 1952 long-term capital gains and losses were "taken into account" only to the extent of 50 per cent, while short-term gains and losses were "taken into account" in full. This meant that a taxpayer with a long-term profit of $200 and a short-term loss of $100 would break even for tax purposes. Some of the manipulations with short sales and similar devices were designed to produce this happy combination of long-term gains and short-term losses. See Brach, "Investor Short Sales," *11th Annual N.Y.U. Inst. on Fed. Taxation* 1 (1953). Even before the enactment of § 1233(b), the Bureau had ruled that such attempts to transmute short-term gains in commodity futures into long-term gains would be disregarded for tax purposes because they were not in accord with the realities. Mim. 6243, 48-1 C.B. 44. *Cf. Deal* v. *Morrow*, 197 F.2d 821 (5th Cir. 1952). Four years later the Mimeograph was amended so that it would not have retroactive effect. Mim. 6789, 52-1 C.B. 38.

Note that an asset must be held "for more than 6 months" for the gain or loss to be long-term. § 1222(3) and (4). Property bought on June 19 and sold on December 19 has been held not to qualify, on the ground that the date of acquisition must be excluded. *Fogel* v. *Commissioner*, 203 F.2d 347 (5th Cir. 1953). Moreover, the court held that "month" means a calendar month, whether it includes 28, 29, 30, or 31 days. This means that property bought in February, September, or November need be held only 182 days to qualify, while property acquired in March, May, or July will have to be held 185 days. Moreover, the Bureau has ruled that the period January 31 to February 28 is one month, so that property bought on August 31 and sold on March 1, though held for only 181 days, will qualify for long-term treatment. I.T. 3985, 49-2 C.B. 51.

In the case of transactions effected through a broker on the organized securities exchanges, the customer's order is executed on a "contract" or "trade date," with delivery and payment postponed for several days to the "settlement date." It is the former date that controls for tax purposes; the customer's holding period

begins the day after the purchase order is executed and ends on the day the sale order is executed. I.T. 3705, 45 C.B. 174.

Section 1223 sets out a number of occasions on which the taxpayer may "tack" to his holding period for a specific asset the time he held some other property or the period some other taxpayer held the same or other property. Periods which can often be thus "tacked" to the time the taxpayer held property include: the time the taxpayer held stock on which he received a tax-free dividend; the time a taxpayer held property exchanged in a tax-free transaction for other property; and the time a taxpayer held stock that was disposed of in a "wash sale" on which the loss was disallowed by § 1091. Before 1954, "tacking" was permissible in the situations set out by § 1223, even though the earlier property was not a capital asset, G.C.M. 25301, 47-2 C.B. 83, but for exchanges after 1954, § 1223(1) is more restrictive.

When a number of assets are sold at the same time, it is necessary to compute the holding period separately for each one. In *Paul* v. *Commissioner*, 206 F.2d 763 (3d Cir. 1953), involving a sale of real estate where the land had been held for more than six months but a building had been completed just before the sale, the Commissioner allowed the profit on the land to be treated as long-term capital gain but asserted that the profit on the building was short-term because its holding period commenced only with its completion. The court held that the taxpayer could allocate part of his profit on the building to the portion that was erected more than six months before the sale, and report it as long-term capital gain; if he could convince the Tax Court of an appropriate allocation, the profit on the rest of the building would be a short-term gain. The court did not indicate how the profit should be allocated; conceivably the taxpayer might prove that the entire profit was attributable to excavation and structural work completed more than six months before the sale and none to the more recently completed trim and interior finish.

MILLIKEN v. COMMISSIONER

U S. Court of Appeals, Second Circuit, 1952
196 F.2d 135, cert. den. 344 U.S. 884, reh. den. id. 910 (1952)

Before SWAN, Chief Judge, and CLARK and FRANK, Circuit Judges.

CLARK, Circuit Judge.

Both the taxpayer, Seth M. Milliken, and the Commissioner of Internal Revenue have appealed from a decision of the Tax Court, 15 T.C. 243, finding an overpayment by the taxpayer of $28,805.83 in his income and victory taxes for the year 1943. The transactions giving rise to the two disputed issues on taxpayer's appeal are as follows. In 1922, his brother, Gerrish H. Milliken, contracted to buy the taxpayer's shares of stock in Cotwool Securities Corporation — or, as it was later called, Cotwool Manufacturing Corporation — at current book value at any time the taxpayer called upon him to do so. When taxpayer invoked the agreement in 1940, however, Cotwool's actual assets were worth far less than the stock's value on the books and Gerrish was therefore unwilling to go through with it. In substitution a new contract was effected on June 28, 1940, whereby taxpayer sold the stock to Gerrish at market value and received an option to purchase, also at market value as of that date, certain of the corporation's assets.

Among these were certain demand notes of a Whitney Manufacturing Company. Taxpayer exercised his option as to these on November 13, 1941, paying the agreed price of ten cents per thousand or a total of $3.05 for participation to the extent of $30,527.25. On December 26, 1941, taxpayer was paid interest of $4,726.65 then due, and on March 5, 1942, he was paid the full face value of his participation. In his return he reported the net amount of $30,524.20 as a short-term capital gain, and this view of the transaction was approved by the Tax Court, though on argument the Commissioner contended that it was ordinary income, and taxpayer in turn that it was a tax-free return of capital or, in the alternative, a long-term capital gain. . . .

The other issue presented on the taxpayer's petition, namely, the correctness of the decision that the net amount he received in payment for his participation in the Whitney notes was a short-term capital gain, requires somewhat fuller development. Here we have an ingenious argument by him that this transaction constituted either wholly or partially a return of capital or was a long-term capital gain. We are not clear how far this argument was developed below, since it is not discussed at all in the opinion of the Tax Court. On this phase of the case the judge contented himself with answering only the Commissioner's argument that this was ordinary gain, as apparently not within the statutory definition, I.R.C. § 117(f), of an "exchange" for the purposes of computing capital gain or loss from a "retirement" of corporate bonds or notes. Since the Commissioner has not appealed from the ruling, that issue is not before us. Moreover, since the Commissioner has failed to reply to the taxpayer's argument, we have been forced back upon our own resources, which we can only hope will prove adequate for adjudication.

The major premise of the taxpayer's argument is the conclusion that the exercise of the option in November, 1941, was a capital transaction and therefore taxable to the amount of the value of the notes when received. If this is accepted and it is further assumed that the value of the notes when received is ascertainable, that value then constitutes a new basis to be used when they were paid off and only the excess over this basis constitutes capital gain in March, 1942. The remainder would then be a tax-free return of capital. On the other hand, if the value is unascertainable or zero he contends that the basis must then derive from the 1940 agreement creating the option. Thus under the *Burnet* and *Carter* cases cited *supra* he would push back the period of holding to this date and make the 1942 retirement of the notes a long-term capital gain.

We cannot agree. In the first place the exercise of the option could not be a capital transaction creating a new basis for the option property. For the taxpayer to argue that the Commissioner should have taxed his option exercise in 1941—a position inconsistent with his apparent failure to report it, see *Orange Securities Corp.* v. *C. I. R.*, 5 Cir., 131 F.2d 662—assumes that the amount of the value of the notes which should have been taxed then as gain would be his new basis when the notes were later retired. Such a concept is distinctly at odds with the mandate of I.R.C. § 113 (a), that "The basis of property shall be the cost of such property," not its value. The basis of the notes must be not the value of the option which was given up (or its equivalent, the value of the option property), but rather the final cost of the notes to the taxpayer. *C. I. R.* v. *Cummings*, 5

* Discussion of the first issue has been omitted [Ed.]

Cir., 77 F.2d 670, 673, specifically approved in *Helvering* v. *San Joaquin Fruit & Investment Co.*, 297 U.S. 496, 498, 56 S. Ct. 569, 80 L. Ed. 824. The value of notes when received is thus irrelevant and cannot be exploited in support of a contention that their payment was partially or wholly a return of capital. See also *C. I. R.* v. *Oxford Paper Co.*, 2 Cir., 194 F.2d 190.

As to the correlative argument that this was a long-term capital gain, taxpayer has ignored the impact of *Helvering* v. *San Joaquin Fruit & Investment Co*, *supra*. That case, the authority of which this circuit has honored as recently as *Kinkel* v. *McGowan*, 2 Cir., 188 F.2d 734, explicitly prescribes that the period during which option property is deemed to be held begins with the date that property was actually acquired through exercise of the option. See also *Mack* v. *C. I. R.*, 3 Cir., 148 F.2d 62, certiorari denied 326 U.S. 719, 66 S. Ct. 23, 90 L. Ed. 425. Thus where, as here, an option is secured more than six months prior to the sale of the property, but the date the option is exercised falls within six months of the sale, the latter only determines the period during which the gain or loss accrued.[1]

The *Burnet* and *Carter* cases cannot override this simple rule, for they have no application to the period of holding. Contrary to taxpayer's contention, they can neither push the acquisition date back nor advance the time of a sale or exchange for purposes of the long term-short term dichotomy. The principle announced in those cases extends only to the nature of payments on speculative contracts of unascertainable value received in a prior capital transaction; though it permits the taxpayer to treat such payments as return of capital or capital gain rather than ordinary income, it does not vary the period during which the property given in exchange for such contracts was held. Hence if this is less than six months, the future payments in a *Carter* and *Burnet* type obligation must be short-term capital gain, no matter how long after the exchange they are received.

Treating the amount in question as a short-term capital gain taxable to the extent that it was a gain on cost, there still might arise an interesting question as to the components of the cost figure here, to wit, whether only the amount paid on exercise or that amount plus some apportionment of the original cost of the option should be included. But that interesting question is not before us. The evidence bearing upon such cost or clarifying the complicated transaction which gave rise to the option was not developed of record; and, after the opinion of the court below, the parties filed an agreed computation upon which the court based its order of overpayment. Hence no issue as to such computation remains open or has been presented to us. . . .

Note

See § 1234, derived from § 117(g)(2) of the 1939 Code.

[1] Note the similar rule for determining the period for which a taxpayer has held stock or securities of a corporation, acquired through the exercise of rights, which includes "only the period beginning with the date upon which the right to acquire was exercised." I.R.C. § 1223 (6). See E. T. Weir, 10 T.C. 996, affirmed per curiam, Weir v. C. I. R., 3 Cir., 173 F.2d 222.

CHAPTER 6

THE CORPORATION AND ITS STOCKHOLDERS

Section A. Introductory

GOODE
THE POSTWAR CORPORATION TAX STRUCTURE
IN HOW SHOULD CORPORATIONS BE TAXED?

New York. Tax Institute, Inc., 1947, pp. 46-58 *
(Reprinted by Permission)

Criticisms of the present corporate income tax and suggestions for its revision center largely around the so-called "double taxation" of distributed corporate profits. Corporations now pay a tax on their profits, and stockholders pay a personal income tax on dividends received. Most plans for reform of the present method of taxing corporations are intended to reduce or eliminate this so-called "double taxation" of distributed profits.

NATURE OF THE PROBLEM OF "DOUBLE TAXATION" OF CORPORATE PROFITS

For a number of reasons I believe that the use of the term "double taxation" is unfortunate. In the first place, the emotional content of the words "double taxation" is enough to condemn the present system in the minds of most people without further hearing. It may be that the present method of taxing corporate profits should be fundamentally revised, but the issue should be argued out fully and carefully and not decided on the basis of colorful phrases. In the second place, the real problem seems to me not to be "double taxation" in the sense of simultaneous imposition of two taxes but how the taxation of corporate profits and stockholders compares with taxation of other kinds of income and other income recipients.

Under the present system, the corporate tax strikes profits distributed to stockholders not subject to individual income tax, either because of low-income or tax-exempt status, although other income going to the same income recipients is not taxed. In this case dividends are taxed more heavily than other kinds of income even though there is no double taxation in the literal sense. On the other hand, profits retained in corporations controlled by high-income stockholders may bear a smaller current tax than other income under the control of the same individuals

It seems to me that discussion would be advanced by substituting for "double

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taxation" such colorless terms as "relative overtaxation" or "relative undertaxation." Instead of talking about removal of "double taxation," it seems better to speak of equalizing taxes on corporate profits and other kinds of income. Whether one finds a specific proposal acceptable may well depend on whether one is more concerned with eliminating "double taxation" in the literal sense or with equalizing taxes on different kinds of income.

Several charges have been brought against the present so-called "double taxation" of corporate profits or, as I should prefer to say, the present relative overtaxation of corporate profits. The first charge is that the present system is inequitable. The first principle of equity in taxation is often held to be to tax all natural persons with the same income at the same rate. By this standard it is indeed true that stockholders are often overtaxed. At other times, however, many stockholders are at least temporarily undertaxed. The rule of equal taxation of equal incomes is subject to modification in accordance with the principle of reasonable classification.

It may be argued in support of the present system that differences in taxation of stockholders and other income recipients are a reasonable reflection of genuine differences between stockholders and others. Within the limits of this paper, I cannot pretend to dispose of this issue. A complete discussion of it would, in my opinion, require a thoroughgoing analysis of the corporate income tax and its far-reaching effects on the distribution of income and wealth, on consumption and saving, on incentives and investment, and on employment and national income.

A second charge against the present corporate tax system is that it reduces the incentive to invest and thus reduces national income or slows its growth. In large part, I believe, this criticism is actually a complaint against income taxes in general rather than against the corporate income tax in particular. If, however, corporate profits are taxed more heavily than other kinds of income, the corporate tax may be especially harmful to investment.

In connection with investment incentives it should be noted that the present "double taxation" or "relative overtaxation" of distributed corporate profits is greatest in the case of low-income stockholders and least in the case of high-income stockholders. This is true because the progressive rates of the individual income tax partly offset the effect of the corporate tax on the distributed part of profits. In the case of profits distributed to high-income stockholders who are subject to high individual tax rates, the tax collector would get a much bigger cut at the individual level if he did not get so much at the corporate level. For example, only 30 cents out of each dollar of the corporate tax on profits distributed to a stockholder subject to a 70 per cent marginal individual rate is net revenue to the Treasury or net additional tax on the stockholder's equity. But, 81 cents out of each dollar of corporate tax is net additional tax in the case of profits distributed to a stockholder subject to only a 19 per cent individual rate.

Two other charges against the present method of taxing corporations, which seem to me somewhat less important than those already mentioned, also stem from the present so-called "double taxation" or "relative overtaxation" of distributed profits. The present tax system is held to favor debt financing as compared with equity financing and to discourage the corporate form of doing business.

I shall not attempt to evaluate these charges nor even to state the counterargu-

ments in favor of the present corporate tax I do want to say that I think that none of the arguments on either side can be accepted uncritically and that, in my opinion, a great deal more analysis needs to be done on the questions raised. For present purposes it is enough to point out that the validity of the case against the present corporate tax depends in large measure on the actual extent of "double taxation" or "relative overtaxation" of corporate profits as compared with other kinds of income.

The present relative overtaxation of corporate profits is neither so extensive nor so heavy as might be supposed on the basis of superficial examination. Unfortunately, however, it does not seem possible at the present stage of economic analysis to set definite limits to the actual extent of existing relative overtaxation of corporate profits. This is true mainly because we do not know with any degree of certainty who actually pays the present corporate tax. If the tax is passed forward to consumers in the form of higher prices or backward to workers in the form of lower wages, as many believe, stockholders may not be taxed more heavily than other income recipients. To the extent that the corporate tax is shifted forward in higher prices, it is no more a "double tax" on stockholders than, say, the excises on alcoholic beverages are double taxes on stockholders in distilleries, breweries, and wineries If, and to the extent that, the corporate tax is shifted, it becomes in effect a broad consumption tax and must be so appraised.

Economic and business opinion is divided on the critical issue of shifting. Indeed, the division of opinion goes so deep that sometimes the same individual or group advances arguments that seem conflicting because of inconsistent treatment of the subject of incidence. Without going fully into the subject, I wish only to raise the question of shifting of the corporate tax as a possible limitation on the validity of the criticisms against the tax and as a point that may be pertinent to the appraisal of the various proposals for modifying the present system.

Even if the corporate tax is not shifted to commodity prices or wages, present stockholders may in many cases largely escape the tax The basis for this assertion is the familiar theory of tax capitalization and amortization. If present stockholders bought their shares with the expectation that the corporate tax would continue, they probably took the tax into account in deciding how much to pay for stocks. Probably stock prices decreased or did not rise as much as they otherwise would have. Present stockholders in many cases may have bought their shares at prices and yields that at least in part discounted the tax To the extent that they did so, the corporate tax was transformed into a one-time levy on the previous owners of stock, and its unexpected repeal or reduction would give present stockholders windfall gains. It is, of course, impossible to appraise this possibility in quantitative terms

Furthermore, the effect of the corporate tax has probably not been confined to stock prices but probably has spread to all kinds of earning assets As stocks became a less attractive investment after imposition or increase of the corporate tax, some potential investors probably attempted to shift to bonds and other assets. The result was doubtless that the prices of bonds and other assets were bid up to some extent, while the fall of the price of stocks was somewhat cushioned If this happened, the corporate tax was the cause of a general decrease in yields of all kinds of earning assets rather than merely a tax on the yield of stocks.

Problems in Shifting to a New Method of Taxing Corporate Profits

One important problem in shifting to a new method of taxing corporate profits would be to prevent or to minimize tax postponement and avoidance on the part of stockholders. Few critics would suggest outright repeal of the corporate tax without any other change. Such action would open the way for stockholders to escape or postpone personal taxes on their part of undistributed corporate profits. With present low tax rates on long-term capital gains, the opportunities for tax avoidance would be especially tempting. If corporate savings were exempt from taxation, other savings could not in fairness be taxed. But exemption of savings would transform the income tax into a spendings tax, which would be a drastic remedy for any existing "double taxation" or relative overtaxation of distributed corporate profits. Consequently, most suggestions for revision of the corporate tax contemplate keeping a tax on retained corporate profits while decreasing present taxes on distributed profits.

Another transitional problem in adoption of a new method of taxing corporate profits would be to minimize possible windfall gains to present stockholders. If a new tax system resulted in lower taxes on corporate profits than the securities markets had generally anticipated, windfall gains could not be wholly avoided. If it is true that the effect of the corporate tax has spread to the prices and yields of all kinds of assets, windfall gains for stockholders would be accompanied by windfall losses for owners of bonds, real estate, and perhaps other earning assets. While such windfall gains and losses could not be wholly avoided, their impact might be softened and their secondary effects lessened by spreading the tax adjustment over a period of years.

Approaches to Equalization of Taxes on Corporate Profits and Other Kinds of Income

Partnership Approach. The partnership approach carries to its logical conclusion the view that there is no genuine distinction between corporations and their stockholders, which is implicit in many criticisms of the present corporate tax. The partnership approach would eliminate the corporate income tax and would tax stockholders on their proportionate part of corporate profits when earned whether the profits were distributed or retained by the corporation. Presumably, stockholders would also be allowed to take account of their proportionate part of corporate losses. The partnership approach would completely eliminate any "double taxation" of corporate profits and would completely equalize taxation of corporate profits and other kinds of income. No stockholder's personal tax liabilities would ever be affected by the dividend policy of the corporation. In this respect, the partnership approach is an ideal system against which other proposals for equalizing taxes on corporate profits and other income must be measured.

But from a practical point of view it seems very doubtful that the partnership approach would be an "ideal" system. It seems extremely doubtful that the partnership technique could be successfully applied to big corporations with many stockholders and complicated capital structures. Aside from the work required to allocate earnings among thousands or hundreds of thousands of stockholders,

the partnership method would involve the almost insoluble problem of distributing profits according to the different kinds of claims represented by a hierarchy of securities

I am not prepared to say whether the partnership method would be feasible and appropriate for small corporations. It does seem to me, however, that as a general method the partnership approach must be regarded as an ideal to be approximated rather than a goal to be reached. I hasten to say that it is an "ideal" only in the sense of equalizing taxes on corporate profits and other kinds of income. Saying that a corporation is nothing more than a sophisticated partnership does not make it so Personally, I want to leave open the question whether elimination of special taxes on corporate profits is desirable in the light of all relevant equity and economic considerations.

Adjustment at the Corporate Level Another approach that has been suggested to the equalization of taxes on corporate profits and other kinds of incomes is to grant corporations a tax credit when they pay dividends or to exclude all or part of dividends paid from taxable corporate income. Stockholders would pay the usual personal taxes on dividends when received. This approach would continue a corporate tax on retained profits but would reduce or eliminate the corporate tax on distributed profits The corporate tax on retained profits would be intended to minimize possibilities for stockholder tax postponement or avoidance, but it would relatively overtax the part of retained profits allocable to low-income stockholders. If a full tax credit or exclusion were allowed corporations for dividends paid, this system would approach the partnership ideal as closely as any other leading proposal

The dividends-paid-credit approach could practically eliminate the present premium on debt financing and the present tax discrimination against the corporate form of doing business. The approach would also lower any tax barriers that may now exist to corporate investment It would be well calculated to counteract any tendency of corporations to shift their taxes to consumers and wage earners.

Another characteristic of the dividends-paid-credit approach may be considered either an advantage or a disadvantage depending on one's point of view. This approach would probably stimulate corporations to pay larger dividends Management and stockholders would see that taxes could be lowered by increasing dividends. Some observers fear that a tax inducement to distribution of profits might lead corporations to deprive themselves of needed funds and so reduce investment Others believe that investment is better allocated if submitted to the test of the capital market than if financed by retained earnings. This is another issue that is too broad to be disposed of within the limits of this paper. Perhaps I should emphasize, however, that, while a tax credit for dividends paid might *induce* some corporate managements to be imprudent, it would never *force* them to be so A corporation could retain as much profits under a dividends-paid-credit plan as under any other plan that imposed a similar tax rate on retained profits. Moreover, it would be possible under the dividends-paid-credit approach to recognize the special capital-raising problems of small corporations by treating a limited amount of profits as if distributed even though retained.

Administration of the dividends-paid-credit approach would be rather simple, since all adjustments would be made at the corporate level

Adjustment at the Individual Level: Withholding approach. The withholding approach would consider all or part of the corporate tax as a withholding tax or an advance payment on the liabilities of stockholders. Corporations would continue to pay a tax on both distributed and undistributed profits, but dividend recipients would be allowed to take credit for the tax paid by the corporation on their share of distributed profits. Dividend recipients would include in their taxable income cash received plus withholding tax but would get credit for the withholding tax. If the amount withheld by the corporation exceeded the stockholder's personal tax liability, he would get a refund from the Treasury. This system, which is used in Great Britain, would be somewhat similar to the present method of withholding on salaries and wages.

The withholding approach would be closely similar to the dividends-paid-credit approach except for making the tax adjustment at the individual rather than the corporate level. Both approaches could completely equalize taxes on distributed corporate profits and other forms of income. Taxes could be entirely eliminated on dividends going to nontaxable stockholders and the same tax imposed on other dividends as on interest and other kinds of income. Both approaches would continue a tax on retained corporate profits in order to reduce individual tax postponement or avoidance.

The withholding approach could reduce or practically eliminate the tax discrimination against equity financing and against the corporate form of organization. In the long run it might counteract any tendency for the corporate tax to raise prices and lower wages, but in the short run the withholding approach would be less likely to eliminate the tax as a factor in price and wage decisions than would a tax adjustment at the corporate level.

If corporate officials and stockholders acted quite rationally, the withholding approach should have the same effect on dividend policy as the dividends-paid-credit approach. In both cases stockholders could gain the advantages of the plan only if profits were distributed. Perfectly rational stockholders would bring as much pressure on management to distribute profits under one plan as under the other. It must be admitted, however, that, given present management and stockholder psychology, the withholding approach would probably be a less powerful stimulus to increased dividends than a dividends-paid-credit plan.

A withholding system would raise some rather troublesome administrative problems, but probably no insuperable ones. For example, it would be necessary to trace dividends back to the corporate income from which paid in order to determine how much tax credit for withholding to allow stockholders. It would also be necessary to grant every dividend recipient a proper tax credit and in many cases to make refunds for overwithholding.

Dividends-received-credit approach Another possible approach at the individual level would be to exempt dividends from a part of the individual income tax. Usually this approach contemplates exemption of dividends from the first bracket of the individual income tax, which would be equal to the corporate tax rate. But equality of the corporate rate and the individual first-bracket rate is not a necessary feature of the approach.

The dividends-received-credit approach could eliminate "double taxation" in the literal sense by making sure that dividends never bore two taxes. But this ap-

proach could not eliminate relative overtaxation of distributed corporate profits. It could not approximate the partnership ideal so closely as the dividends-paid-credit approach or the withholding approach. The dividends-received-credit approach would grant no relief to stockholders not subject to the individual income tax. While these stockholders are not doubly taxed in the literal sense, they are overtaxed on dividends as compared with other kinds of income.

Nor would the dividends-received-credit approach equalize taxation of corporate profits and other kinds of income going to high-income stockholders This approach would, in effect, consider the tax paid by the corporation as a payment on the tax liability of stockholders. But unlike the withholding approach, it would not require stockholders to include in their taxable income the tax paid on their behalf by the corporation. This would benefit high-income stockholders subject to high surtax rates more than low-income stockholders subject to low surtax rates. Although the dividends-received-credit approach could eliminate "double taxation" in the narrow sense and reduce the tax load on corporate profits, it could not so nearly equalize taxation of corporate profits and other kinds of income as could the dividends-paid-credit approach and the withholding approach.

It ought to be recognized that the dividends-received-credit approach would in effect introduce a new scale of graduated tax rates for distributed corporate profits. This new scale would start higher than the rate on other income but would end lower than the rate on other income This may be a defensible rate scale, but its merits are not obvious; they would have to be established explicitly, in fair competition with the claims of other possible schedules.[1]

The dividends-received-credit approach could reduce, but not wholly eliminate, tax discrimination against equity financing and against the corporate form of doing business This approach would be simple to administer

3. Dividend-exclusion approach. Another approach would be to allow stockholders to exclude a part of dividends received from their taxable incomes. This approach would reduce taxes on corporate profits, but it could not equalize the taxation of corporate profits and other kinds of income. The tax value of the exclusion of dividends would equal the present relative overtaxation of dividend income only by coincidence and then only for one taxable income bracket. All other stockholders would get either a smaller or a larger benefit. Nontaxable stockholders would get no benefit at all.

It is clear that the tax value of the dividend exclusion would vary directly with the surtax rate applicable to the stockholder's dividend income. Thus, high-income stockholders would benefit substantially from the dividend-exclusion approach while low-income stockholders would benefit much less or not at all

[1] If, as is usually suggested, the corporate tax rate and the individual first-bracket rate were equal, the *combined* corporate and individual taxes on distributed profits would be lower than the rate on other kinds of income for all stockholders subject to more than the first-bracket individual rate. In such cases, the combined taxes would be less than the individual tax alone that would apply if there were no corporate tax and dividends were subject only to regular individual rates. Suppose, for example the corporate tax and the first-bracket individual rate were both 20 per cent and that Stockholder A were subject to a 50 per cent individual rate, made up of the 20 per cent first-bracket rate and 30 per cent higher bracket rates On $1.00 of profits a corporation would pay 20 cents in tax, on the remaining 80 cents of cash dividends, A would pay 24 cents in tax, the combined corporate and individual taxes would be 44 cents Yet, if there had been no corporate tax, A would have paid 50 cents in the individual tax on $1 00 of dividend income

The allocation of tax reductions among different stockholders under the dividend-exclusion approach would not approximate the present overtaxation of distributed corporate profits as measured against the "ideal" standard of the partnership approach. Like the dividends-received-credit approach, the dividend-exclusion approach would in effect provide a new scale of graduated rates for distributed profits—a scale beginning relatively high and ending relatively low.

Conclusions

The problem of corporate tax reform is complicated by uncertainty as to the real effects of the present system, but the discussion has been enriched by the number of different plans suggested. Among the main approaches, only the partnership approach could completely equalize taxation of corporate profits and other kinds of income. But both the dividends-paid-credit approach and the withholding approach could equalize taxes on distributed profits and other income, while continuing a corporate tax on retained profits. The dividends-received-credit approach and the dividend-exclusion approach could reduce taxes on distributed profits but could not equalize taxes on this and other kinds of income.

While the problem of relative overtaxation of corporate profits is at the root of most criticisms against the corporate tax, the objective of equalizing taxes on corporate profits and other kinds of income is not the only factor to be considered in designing the postwar corporation tax structure. One controlling condition is revenue adequacy. Moreover, possible economic gains from remodeling the present structure can be appraised only by comparing the effects of the present corporate tax on consumption, investment, and national income with the effects of other taxes, which would have to be higher than would otherwise be necessary if the tax on corporate profits were lower.

Note

1. The 1954 Code, as was seen *supra*, p. 194, permits the first $50 of dividends received by an individual taxpayer to be excluded from gross income; in the case of a joint return, husband and wife may each exclude $50 if each receives that much dividend income A dividends received credit of 4 per cent of the balance of the taxpayer's dividends is also allowed. This credit may not exceed 2 per cent of the taxable income in 1954 or 4 per cent in later years Sections 34 and 116. What is the purpose of the 2 per cent-4 per cent limitation?

As proposed by the House Ways and Means Committee and passed by the House of Representatives, the Code provided a credit that would rise to 10 per cent of dividends received after July 31, 1955. The credit was the most controversial part of the Code, and the House divided along party lines on a vote to recommit the bill to committee with instructions to strike the credit and substitute an increase in the personal exemption from $600 to $700 The motion was rejected by 204 (193 Democrats, 10 Republicans, 1 Independent) to 210 (201 Republicans, 9 Democrats).

The Senate eliminated the credit (though it retained the $50 exclusion) and substituted a provision directing the Secretary of the Treasury "to make a study of questions involving the inclusion in gross income of dividends received by individuals and to report to the Congress on or before January 15, 1955" In doing so, the Senate rejected the recommendation of the Senate Finance Committee, which had favored the credit. As the bill went to conference to iron out the differences between the House and the Senate versions, Chairman Reed of the House Ways and Means Committee was quoted by the newspapers as saying. "We'll get the House version or not have a bill." (*New York Times*, July 4, 1954, p. 16, col. 3.) The House won out

in conference on this issue, but it accepted most of the other Senate changes in the bill.

2. The Senate bill adopted another approach to the "double taxation" of corporate earnings. It authorized certain closely-held corporations organized after December 31, 1953, to elect to be taxed as partnerships, a corporation could qualify only if it had no more than ten shareholders, all of whom were individuals actively engaged in the conduct of its trade or business. and there were other restrictions as well. The proposal was eliminated in conference, no reasons being given in the conference committee's report.

3. Section 1361, permitting certain unincorporated business enterprises (both partnerships and individual proprietorships) to elect to be taxed as corporations, is new in the 1954 Code An enterprise will not qualify if it is owned by more than fifty persons, and it is necessary that capital be a 'material income producing factor" or that 50 per cent or more of gross income consists of gains, profits, or income derived from trading as a principal or from acting as a broker in sales of real property, commodities, or stock, or securities. Ordinarily, of course, any enterprise that wishes to be taxed as a corporation can achieve its aim easily enough, by organizing in corporate form. Lawyers, doctors, and other professionals who are not permitted to practice in corporate form will not be able to take advantage of Section 1361, because they will be unable to meet the capital or gross income requirements. But members of the New York Stock Exchange, who are forbidden by its rules to incorporate, and other individuals and partnerships that do not wish to limit their personal liability may now continue to do business in unincorporated form while being taxed as corporations.

LOWNDES
TAXING THE INCOME OF THE CLOSE CORPORATION

18 Law & Contemp. Probs, 558-565 (1953)
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Although there is no substantial agreement about how the income from close corporations should be taxed, there appears to be virtual unanimity with respect to the defects of the present system.

The basic weakness of the method adopted by the federal income tax for taxing corporate income is that it is predicated upon a legal fiction which ignores economic realities. In the case of a partnership, the partnership is disregarded and the partners are taxed directly upon their distributive shares of the partnership income.[1] In the case of a corporation, however, the law gives full credence to the corporate fiction. Although in substance a close corporation represents an incorporated partnership, or perhaps an incorporated sole proprietorship, the corporate entity is treated as an independent taxable entity, and the income of the undertaking is taxed to the legal convention, rather than to the real owners of the enterprise.

The recognition of the corporation as a distinct taxable entity has several unhappy corollaries. Even in the case of the publicly owned corporation, it results in a complete disregard of the ability to pay principle, which is supposed to be one

[1] The first federal income taxes, passed during the Civil War, taxed the income of corporations in the same way, that is, they ignored the corporate entity and taxed the shareholders directly upon their distributive shares of the corporate income This system was sustained in Collector v Hubbard, 12 Wall. 1 (U S 1870), although the Supreme Court later repudiated the Hubbard case in Eisner v. Macomber, 252 U S 189, at 217-219 (1920), declaring that "the stockholder's share in the accumulated profits of the company is capital, not income" (p 219), and that he realizes no income upon which he may be taxed under the Sixteenth Amendment until the corporate profits are distributed to him in the form of dividends.

of the cardinal *desiderata* of an income tax. Although there is considerable speculation about the actual incidence of the corporate income tax, and whether the burden of the tax is shifted to the consumer in the form of higher prices, or to the corporate employees in the form of lower wages, or to the stockholders in the form of diminished dividends, it is clear that the actual burden of the tax is not imposed upon the corporation, which is a legal fiction. The corporate tax, which in recent years has been graduated according to the size of the corporate income, obviously bears no relation to the wealth or the ability to pay of the person who actually pays the tax, whoever he may be.

In the case of close corporations there are more fundamental objections to the current system of taxing corporate income. Some taxes are unjust because they bear too heavily upon a particular class of taxpayers. Others lack equity because they are susceptible to manipulation which makes it possible for the sophisticated taxpayer to shift his legitimate share of the tax burden to some more ingenuous citizen. The corporate tax enjoys the dubious distinction of erring in both directions. Since corporate income is taxed in the first instance to the corporate entity, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, while the income of a partnership or a sole proprietorship is taxed but once to the partners or the sole proprietor, the corporate tax discriminates against incorporated partnerships and incorporated sole proprietorships. On the other hand, the recognition of an artificial legal convention as an independent taxable entity is a constant stimulus to tax manipulation and tax avoidance.

The theoretical objections to the present system of taxing the income of close corporations are that it makes the conduct of a business subordinate to tax considerations and interposes an unwarranted impediment to freedom of choice of the form of business organization, because of the double tax on corporate income, as contrasted with the single tax upon the income of a partnership or a sole proprietorship. Moreover, by treating the corporate personality as a distinct taxable entity, the corporate tax serves as a shield behind which the tax dodger may conduct his maneuvers with impunity.

The ultimate test of a tax, however, lies in the practical operation of the tax in a concrete context, rather than its theoretical imperfections. The present system of taxing the income of close corporations must be judged by whether it really does create a genuine obstacle to conducting a business as a corporation rather than a partnership or sole proprietorship, and whether it actually encourages tax manipulation and tax avoidance.

Choice of Form of Business Organization: The Close Corporation Versus the Partnership or Sole Proprietorship

It is difficult to determine the precise extent to which the present system of taxing the income of close corporations constitutes a genuine impediment to the selection of the corporate form to conduct a business, which could be carried on as a partnership or sole proprietorship, because the relative tax advantages and disadvantages of various forms of business organization are linked so intimately with the concrete facts of a particular situation. In some cases it may actually be more economical to do business as a corporation. In others, a partnership or a sole proprietorship is preferable from a tax point of view. Unquestionably, the fact that the income of a close corporation is taxed differently than that of a part-

nership or a sole proprietorship is a predominating factor in the selection of the form of business organization. It is not, however, a consideration which inclines constantly in the same direction, since the tax advantages of one form of organization over another shift continually with changes in the underlying factual situation

Because the tax advantages of a particular form of business organization are tied so closely to the unique facts of the particular situation, it is impossible to lay down any rigid rule which can be applied indiscriminately in every case to determine the most economical form of doing business from a tax point of view. It is feasible, however, to point out some of the major tax factors which must be weighed in choosing a form of business organization to illustrate the unwarranted predominance which tax considerations have achieved in this area, because of the identification of the corporation as an independent taxable entity.

A. Rates

A basic consideration in the choice of a corporation or a partnership or sole proprietorship as a form of business organization is the matter of rates, since corporate income is taxed under a different rate schedule than that applied to individual income, and corporate income is subject to the excess profits tax, which does not apply to other types of income.* There is, however, no constant ratio between the corporate tax and the individual tax, since this depends upon such variant factors as the size of the income, the application of the excess profits tax, and the personal status of the individual taxpayer. The recent revenue acts, which have reimposed the excess profits tax and permitted married taxpayers to split their incomes, have tended to favor partnerships and sole proprietorships, rather than corporations, as a form of business organization. However, the actual rate, at which the income from an enterprise is taxed, depends to such an extent upon the unique facts of the particular situation that it is impossible to generalize about which rates are more favorable.

B. Double Taxation

An important factor in determining the actual *effective* rate of tax upon the income of a close corporation is the possibility of avoiding a double tax. If corporate income is taxed first to the corporation, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, it is obvious that the aggregate tax upon corporate income will be heavier than that which would be incurred by a partnership or a sole proprietorship.† In many cases, however, it is possible to eliminate the double tax. In a given situation it may even be possible to divide the income from an incorporated enterprise between the corporation and the individual entrepreneurs, so that part of the income is taxed to the corporation and part to the individual shareholders, with a lower aggregate tax than if it were all taxed directly to the individual owners of the business.

As a general rule, if the corporate profits can be distributed to the stockholders in a form which is deductible from the corporate income, a business may be conducted as a corporation about as economically from a tax point of view as a part-

* An excess profits tax was in effect during World Wars I and II and during the period 1950-1953. [Ed.]

† The dividends received credit enacted in 1954, *supra*, p 456, of course, moderates the effect of the separate corporate tax to a degree [Ed.]

nership, because of the elimination of any additional corporate tax. Thus, many small enterprises, whose earnings are derived chiefly from the efforts of the owners of the business, are able to operate as corporations without any undue tax penalty, because they can distribute their profits in the form of salaries, which are deductible from the corporate income. In fact, if part of the corporate earnings are plowed back into the business for expansion, it may be more economical to operate as a corporation than a partnership. In the case of a partnership, all of the partnership income is taxed to the partners, regardless of whether it is distributed to them or retained in the business. There is, therefore, no opportunity to divide the income from the business between the partners and the firm. In the case of a corporation, however, if part of the corporate income can be distributed to the shareholders in the form of salaries, or other items deductible from the corporate income, and part can be retained in the corporation, it is possible to divide the income from the enterprise between the corporation and the stockholders, so as to take advantage of the lower brackets under both the corporate and individual taxes.

Of course, matters may not work out so neatly. The deduction for salaries is limited to reasonable salaries, or in the words of the statute to "a reasonable allowance for salaries or other compensation for personal services actually rendered." Moreover, there are restrictions upon the earnings which a corporation may retain without encountering the surtax under Section 102,‡ which is imposed as a penalty upon a corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." The limitation upon the deduction for salaries to reasonable salaries may create an awkward situation, if the particular stockholder needs a greater portion of the earnings of the business than can properly be regarded as reasonable compensation for the services which he renders to the corporation. Furthermore, in order to accumulate earnings in the corporation without incurring the Section 102 surtax, there must be some showing that they are needed for expansion or some independent business purpose of the corporation.

Salaries or compensation for personal services are not the only items which may be deducted from corporate income. Although dividends distributed by a corporation are not deductible in computing the corporate tax, the interest which a corporation pays on its debts is. Consequently, it has become customary to finance a corporation largely with borrowed capital in order to distribute the corporate earnings in the form of interest upon its obligations, which is deductible from the corporate income.... In addition to deducting the interest paid on the obligations of the corporation, it is possible to retain substantial amounts of the corporate earnings in the corporate treasury to fund its indebtedness without incurring the Section 102 surtax. Moreover, the corporation can distribute its earnings by redeeming its bonds, or paying off its debts, without subjecting such payments to an additional tax in the hands of the stockholder-creditors, where a similar distribution in redemption of part of its stock would run the risk of being taxed as an ordinary dividend under Section 115 (g).§

‡ Now, somewhat modified, § 532. [Ed.]

§ The stock-redemption area has been altered by the 1954 Code, *infra*, p. 495, but the general principle still stands. [Ed.]

While thin incorporation has its advantages, there is a still unsettled problem as to just how thin incorporation can get before the Commissioner can see through it. It has been held that if the borrowed capital is substantially disproportionate to the equity capital, the borrowed capital will be treated as equity capital and a deduction for interest paid on the borrowed capital will be disallowed. Moreover there appears to be no manifest reason why the redemption of bonds in such a case could not be taxed under Section 115(g) as an ordinary dividend. It is obvious that while it may be possible to eliminate a corporate tax by paying out corporate earnings in the form of interest rather than dividends, the restrictions on thin incorporations, like the limitation upon the deduction of salaries, make this a matter calling for skillful and sophisticated tax management.

In addition to the distribution of corporate earnings in the form of salaries and interest to minimize or eliminate the corporate income tax, part of the corporate profits are frequently paid out in the form of rent, which the corporation can deduct from its income as a business expense. Under this scheme, the stockholders will retain title to the property which the corporation needs to operate its business and lease it to the corporation, so that the rent paid by the corporation can be deducted from its income. Here again, however, caution must be exercised. If the rent paid by the corporation is in excess of the fair figure which would have been fixed in an arm's length transaction, the excess above the fair rental value of the property will be disallowed as a deduction. It seems possible, moreover, that if the lease simply represents a scheme for diverting income from the corporation and serves no independent business purpose of the corporation, any deduction for rent may be disallowed, while the rent itself may be taxed to the stockholder who receives it as a dividend.‖

C. Tax-Exempt Income, Capital Gains

In addition to the effective rates of tax upon the income of an enterprise conducted as a corporation and as a partnership, there are other differences between the ways in which corporations and partnerships are taxed, which follow as more or less logical corollaries from the recognition of the corporation as a distinct taxable entity, and which must be taken into account in the choice of a form of business organization. One of these differences, for example, is the way in which tax-exempt income of a corporation and of a partnership is treated.

Tax-exempt income of a partnership does not lose its tax-exempt status when it is taxed to the partners, since the partnership is merely a conduit for allocating the partnership income to the partners. Tax-exempt income of a corporation, however, is transmuted into taxable income when it passes through the hands of the corporation and is distributed in the form of dividends, since the exemption is lost by the interposition of an independent taxable entity between the income and the stockholders. The moral, of course, is plain. Tax-exempt or partially tax-exempt income should not be given to a corporation, but should, as far as practicable, be retained by the individual stockholders.

The fact that income may change its character between the time it is earned by a corporation and distributed to the stockholders does not, however, always work to the disadvantage of the stockholders. It is sometimes possible to convert ordi-

‖ See White v. Fitzpatrick, *supra*, p. 358. [Ed.]

nary income of a corporation into a long-term capital gain in the hands of a stockholder by liquidating the corporation. Incidentally, however, there is no profit in transferring capital assets, which have increased in value, to a corporation with the idea of having the corporation sell the assets and realize the gain, since the minimum tax which a corporation must pay upon such a gain is 26 ** per cent, which is the maximum tax which an individual may pay, and he may pay less. Moreover, if the gain realized by the corporation is ultimately distributed to the stockholder it will be taxed to him again, and, unless the distribution occurs in connection with a liquidation of the corporation, taxed as ordinary income.

D. Deferring Gains and Losses

One of the advantages of conducting an expanding business as a corporation, which was noted earlier, is that the earnings which are retained by the corporation may be kept out of the incomes of the stockholders and taxed to the corporation in a lower bracket than they would be taxed to the stockholders. In other words, this is a possible way of dividing the income of a business between the corporation and the proprietors of the business and taking advantage of the lower brackets of both the corporate and individual taxes. On the other hand, if a business is conducted as a partnership or a sole proprietorship, all of the income of the business will be taxed to the partners or to the sole proprietor, regardless of whether it is actually distributed to them or plowed back into the business.

Conversely, however, it may be advantageous to organize a new business, in which losses are anticipated in the early years, as a partnership or sole proprietorship, rather than a corporation, since the losses incurred in starting the business can be utilized directly by the partners or the sole proprietor to offset their gains from other sources, and if they arise from the operation of the business, as distinguished from the sale or exchange of capital assets, they will be fully deductible as ordinary business losses. If, on the other hand, the business is conducted as a corporation, any losses incurred in the operation of the business will be the losses of the corporation and cannot be availed of by the stockholders. Although such losses may give rise to a net operating loss which can be carried over and offset against the profits of later years, if the corporation continues to be unsuccessful and realizes no gains the carry-over cannot be utilized either by the corporation or the stockholders. Moreover, although the stockholders will realize a loss when the corporation is finally liquidated, the loss will ordinarily take the form of a long-term capital loss subject to the restrictions on such losses.

E. Organization and Liquidation

Although theoretically a corporation should pay a heavier tax than a partnership or a sole proprietorship, because corporate income is exposed to the hazard of a double tax, actually the tax burden of a close corporation depends upon a number of adventitious circumstances. Moreover, the circumstances which determine the relative tax advantages of doing business under the corporate form are not static but are subject to constant fluctuation. At one stage in the existence of a business, it may be profitable to operate as a corporation, and at another, as a partnership or

** Now 25 per cent for individuals, for corporations the rate will drop from 26 per cent to 25 per cent for taxable years beginning on or after April 1, 1954. [Ed.]

sole proprietorship. Not only changes in the fortunes of the business, but changes in the law, such as the enactment or repeal of an excess profits tax, permission for married taxpayers to split their incomes, and upward and downward revisions in the corporate and individual rate schedules, may make a change in the form of business organization imperative. In this connection it is important to bear in mind that it is much easier to shift into a corporation than it is to shift out of one.

A partnership can be organized or liquidated without realizing taxable gain or loss. Moreover, a partnership can be converted into a corporation without incurring any gain or loss, if the partners are in control of the corporation after the transfer of the partnership assets to the corporation, and they retain the same proportionate interests in the corporation, which they had in the partnership property.

The recognition of the corporation as a distinct taxable entity, however, usually makes it impossible to liquidate a corporation and shift to a partnership without serious tax consequences

Note

See also Goode, *The Corporation Income Tax* (1951), reviewed by Somers, "The Place of the Corporation Income Tax in the Tax Structure," 5 *Nat'l. Tax J.* 279 (1952), Slitor, "The Corporation Income Tax A Re-evaluation." *id* 289, Groves, *Postwar Taxation and Economic Progress* (1946) 20-73.

Section B. The Corporation As a Taxable Entity

***Note.* Section 7701(a)(3) of the 1954 Code, defining the term "corporation" to include "associations," is identical with § 3797 (a)(3) of the 1939 Code.**

Section 269 of the 1954 Code, relating to acquisitions to evade or avoid income tax, is virtually identical with Section 129 of the 1939 Code, except for the presumption of 269(c), which is new. See Regs. 118, Secs. 39.3797-1-5 and 39.129-1-4.

MORRISSEY v. COMMISSIONER

Supreme Court of the U.S., 1935

296 U.S. 344

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

Petitioners, the trustees of an express trust, contest income taxes for the years 1924 to 1926, inclusive, upon the ground that the trust has been illegally treated as an "association.". . . We granted certiorari because of a conflict of decisions as to the distinction between an "association" and a "pure trust," the decisions being described in one of the cases as "seemingly in a hopeless state of confusion." *Coleman-Gilbert Associates* v. *Commissioner*, 76 F.(2d) 191, 193.

The facts were stipulated. In the year 1921 petitioners made a declaration of trust of real estate in Los Angeles. They were to be designated in "their collective capacity" as "Western Avenue Golf Club." The trustees were authorized to add to their number and to choose their successors, to purchase, encumber, sell, lease and operate the "described or other lands"; to construct and operate golf courses, club houses, *etc.*, to receive the rents, profits and income, to make loans and investments, to make regulations; and generally to manage the trust estate as if the trustees were its absolute owners. The trustees were declared to be without power to bind the beneficiaries personally by "any act, neglect or default," and the

beneficiaries and all persons dealing with the trustees were required to look for payment or indemnity to the trust property. The beneficial interests were to be evidenced solely by transferable certificates for shares which were divided into 2,000 preferred shares of the par value of $100 each, and 2,000 common shares of no par value, and the rights of the respective shareholders in the surplus, profits, and capital assets were defined. "Share ledgers" showing the names and addresses of shareholders were to be kept.

The trustees might convene the shareholders in meeting for the purpose of making reports or considering recommendations, but the votes of the shareholders were to be advisory only. The death of a trustee or of a beneficiary was not to end the trust, which was to continue for twenty-five years unless sooner terminated by the trustees.

During the years 1921 and 1922, the trustees sold beneficial interests and paid commissions on the sales. About 42 acres (of the 155 acres described by the declaration of trust) were plotted into lots which were sold during the years 1921 to 1923, most of the sales being on the installment basis. On the remaining property a golf course and club house were constructed, and in 1923 this property with the improvements was conveyed to Western Avenue Golf Club, Inc., a California corporation, in exchange for its stock. Under a lease from the corporation, petitioners continued the operation of the golf course until January 12, 1924. After that date petitioners' activities were confined to collections of installments of principal and interest on contracts of purchase, the receipt of interest on bank balances and of fees on assignments by holders of purchase contracts, the execution of conveyances to purchasers, the receipt of dividends from the incorporated club, and the distribution of moneys to the holders of beneficial interests. On December 31, 1923, the total number of outstanding beneficial interests was 3016, held by 920 persons; by December 31, 1926, the number of interests had been gradually decreased to 2172, held by 275 persons. The holdings by the trustees ranged approximately from 16 to 29 per cent.

Petitioners contend that they are trustees "of property held in trust," within Sec. 219 of the Revenue Acts of 1924 and 1926, and are taxable accordingly and not as an "association." They urge that, to constitute an association, the applicable test requires "a quasi-corporate organization in which the beneficiaries, whether or not certificate holders, have some voice in the management and some control over the trustees and have an opportunity to exercise such control through the right to vote at meetings"; and that, in any event, the activities in which petitioners were engaged, during the tax years under consideration, did not constitute "a carrying on of business" within the rule applied by this Court.

The Government insists that the distinction between associations and the trusts taxed under Sec. 219 is between "business trusts on the one side" and other trusts "which are engaged merely in collecting the income and conserving the property against the day when it is to be distributed to the beneficiaries"; that Congress intended that all "business trusts" should be taxed as associations.

1. The Revenue Acts of 1924 and 1926 provided·

"The term 'corporation' includes associations, joint-stock companies, and insurance companies." * . . .

* Section 3797(a)(3) of the 1939 Code, § 7701(a)(3) of the 1954 Code. [Ed.]

"Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—whether created by will, deed, or declaration—by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere *cestuis que trustent*, plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking or acquiring of shares of interests sufficient to constitute participation, and may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the cooperative undertaking will differentiate it from an ordinary trust. In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities, or for commerce, or other sorts of business, where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

The Government contends that such an organized community of effort for the doing of business presents the essential features of an association. Petitioners stress the significance of, and the limitations said to be implied in, the provision classifying associations with corporations

The inclusion of associations with corporations implies resemblance, but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts. As we have seen, the classification cannot be said to require organization under a statute, or with statutory privileges. The term embraces associations as they may exist at common law. *Hecht* v. *Malley*, 265 U S 144 (1924) We have already referred to the definitions, quoted in that case, showing the ordinary meaning of the term as applicable to a body of persons united without a charter "but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." These definitions, while helpful, are not to be pressed so far as to make mere formal procedure a controlling test. The provision itself negatives such a construction. Thus unincorporated joint-stock companies have generally been regarded as bearing the closest resemblance to corporations But, in the revenue acts, associations are mentioned separately and are not to be treated as limited to "joint-stock companies," although belonging to the same group While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive Thus an association may not have "directors" or "officers," but the "trustees" may function "in much the same manner as the directors in a corporation" for the purpose of carrying on the enterprise. The regulatory provisions of the trust instrument may take the place of "by-laws"

And as there may be, under the reasoning in the *Hecht* case, an absence of control by beneficiaries such as is commonly exercised by stockholders in a business corporation, it cannot be considered to be essential to the existence of an association that those beneficially interested should hold meetings or elect their representatives. Again, while the faculty of transferring the interests of members without affecting the continuity of the enterprise may be deemed to be characteristic, the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer.

What, then, are the salient features of a trust—when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains—which may be regarded as making it analogous to a corporate organization? A corporation, as an entity, holds the title to the property embarked in the corporate undertaking. Trustees, as a continuing body with provision for succession, may afford a corresponding advantage during the existence of the trust. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The designation of trustees, who are charged with the conduct of an enterprise,—who act "in much the same manner as directors"—may provide a similar scheme, with corresponding effectiveness. Whether the trustees are named in the trust instrument with power to select successors, so as to constitute a self-perpetuating body, or are selected by, or with the advice of, those beneficially interested in the undertaking, centralization of management analogous to that of corporate activities may be achieved. An enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the interests of members of a corporation. And the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants. The trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking.

It is no answer to say that these advantages flow from the very nature of trusts. For the question has arisen because of the use and adaptation of the trust mechanism. The suggestion ignores the postulate that we are considering those trusts which have the distinctive feature of being created to enable the participants to carry on a business and divide the gains which accrue from their common undertaking,—trusts that thus satisfy the primary conception of association and have the attributes to which we have referred, distinguishing them from partnerships. In such a case, we think that these attributes make the trust sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of corporations.

Applying these principles to the instant case, we are of the opinion that the trust constituted an association. The trust was created for the development of a tract of land through the construction and operation of golf courses, club houses, *etc.* and the conduct of incidental businesses, with broad powers for the purchase, operation and sale of properties. Provision was made for the issue of shares of beneficial interests, with described rights and priorities. There were to be preferred shares of the value of $100 each and common shares of no par value. Thus

those who took beneficial interests became shareholders in the common undertaking to be conducted for their profit according to the terms of the arrangement. They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise. The arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried still further by the provision for the issue of transferable certificates.

Under the trust, a considerable portion of the property was surveyed and subdivided into lots, which were sold and, to facilitate the sales, the subdivided property was improved by the construction of streets, sidewalks, and curbs. The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization Its character was determined by the terms of the trust instrument. It was not a liquidating trust, it was still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized....

The judgment is affirmed.

Note

See Regs. 118, Secs. 39.3797-3 and -4 for an attempt to generalize about the differences between an "association" and what the Regulations term an "ordinary trust" Are centralized management and continuity of existence more characteristic of corporations than of trusts, so that an organization that possesses these characteristics should be classified as a corporation? The trustees of a Massachusetts business trust or similar organization are *not* immune from personal liability for their official acts (though they may insure against such liability, seek reimbursement from the trust corpus to the extent thereof, or protect themselves by contract when the parties with whom they deal are willing). The beneficiaries, however, are immune from personal liability. But is their immunity any more characteristic of the stockholders of a corporation than of the beneficiaries an of "ordinary" trust?

If the organization has the legal characteristics (centralized management, continuity of existence, transferable interests, *etc.*) that the Regulations regard as indicia of corporateness, is it necessary that there be business activity as well before a corporation tax will be due? If so, why? Corporations are taxed as such even though the only activity is the holding, conserving, or investing of corporate assets

See Smith, "Associations Classified As Corporations Under the Internal Revenue Code," 34 *Calif. L. Rev.* 461 (1946).

PAYMER v. COMMISSIONER

U.S. Court of Appeals, Second Circuit 1945
150 F 2d 334

Before L. HAND, SWAN, and CHASE, Circuit Judges.

CHASE, Circuit Judge.

These four petitions, which were consolidated for hearing, require us to decide whether the 1938 net income of certain real estate was taxable to the petitioning

corporations each of whom held the title to a part of it, or to the petitioning individuals who owned all the stock of the two corporations. And, if the corporations are taxable on the income, whether their failure to file income and excess profits returns made them liable for a penalty. The Commissioner determined that the corporations were taxable and also that the individuals, to whom the income was paid directly by the lessees of the property, were taxable on the amounts each received on the theory that what was done was the equivalent of dividend distributions by the corporations. He also assessed a penalty against each corporation. The Tax Court affirmed.

The individual petitioners are two brothers, who have been in partnership for many years under the name of Paymer Bros., owning partnership property which has in part been real estate that they improved and managed. Because Samuel had become the co-signer on a note and the guarantor of an account both of which were overdue in 1932, it was then thought that he might be sued by creditors and the partnership property attached. To avoid that, if possible, the partners in that year organized Raymep Realty Corp., Inc. and Westrich Realty Corp., two New York corporations which were given broad powers to own, manage and dispose of real estate and conveyed to each of them a parcel of income-producing real estate in New York City. The conveyance to Raymep was in 1932 and was made directly by the partners. That to Westrich was conveyed first by the partners to Paymer Bros. Realty Corp. Inc., a corporation wholly owned by them, and was then by it deeded to Westrich. In each instance, each of the two partners received half of the stock of the grantee in exchange for the property. The minutes of a meeting of directors and stockholders of each grantee held about the time the property was deeded to it contain the following statement

> The said conveyance was and is made with the express understanding that the corporation is only to hold title to the property, the beneficial interest and profits to be in the individual stockholders and the management and control of the property to be exclusively theirs. It is understood and agreed that this corporation was only organized for the convenience of the shareholders in the management thereof.

After these meetings neither corporate petitioner held any others. Neither ever elected any officers or directors after Samuel was elected president and Joseph treasurer at the organization meeting, ever had any office or bank account, or collected any income. The two partners managed the real estate conveyed as above and collected the income, paid the expenses, deposited the money received in the bank account of Paymer Bros., and used the net profits of the real estate as they pleased, treating that property as the partnership property it had formerly been. The leases existing on the real estate when the conveyances were made were not assigned to the corporations and nothing was done by Westrich in respect to the property held in its name. That is not true, however, as to Raymep for a loan of $50,000 was obtained by it in 1938 and as part security for the loan it assigned to the lender all the lessor's rights, profits and interest in two leases on the property and covenanted that they were in full force and effect and that it was the sole lessor. Capital stock tax returns were filed by both Raymep and Westrich for the fiscal year ended June 30, 1938. During 1938 the two partners received gross rentals amounting to $18,999.86 from the property to which Raymep held the title and $3300. from that whose title was held by Westrich.

The petitioners, acting on the advice of their accountant, included the 1938 income from the property held by these corporations in their own partnership in-

formation return for that year, in which they also included the incomes and expenses of two other corporations wholly owned by them. The net income so reported was treated as the net income of the partners in their returns.

The petitioners now contend that Raymep and Westrich were mere "dummies" which held the legal title to property owned by the two individual petitioners and that both corporations are to be disregarded for income tax purposes As a general rule a corporation is a taxpayer separate and distinct from its stockholders. *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 442, 54 S. Ct. 788, 78 L. Ed. 1348 And this applies to a corporation wholly owned by one stockholder. *Burnet* v. *Commonwealth Improvement Co.*, 287 U S 415, 53 S. Ct. 198, 77 L. Ed. 399. But there are exceptions and the corporate form will be disregarded where it serves no business purpose and is but a sham. *Gregory* v. *Helvering*, 293 U S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A.L.R. 1355 So, too, a taxpayer may gain the advantage of doing his own business through a wholly owned corporation if he pleases, but the treasury may disregard the separate corporate entity where it serves but as a shield against taxation and treat the one who actually may take the benefit of the income as the owner of the property which produces it and tax him accordingly. *Higgins* v *Smith*, 308 U.S. 473, 60 S Ct 355, 84 L. Ed. 406. Yet the treasury may treat a corporation as a separate taxable entity when its organization "is followed by the carrying on of business by the corporation." *Moline Properties* v. *Commissioner of Internal Revenue*, 319 U.S 436, 439, 63 S Ct. 1132, 1134, 87 L. Ed. 1499.

We think that Raymep was active enough to justify holding that it did engage in business in 1938. The absence of books, records and offices and the failure to hold corporate meetings are not decisive on that question Though Raymep was organized solely to deter creditors of one of the partners, it apparently was impossible or impracticable to use it solely for that purpose when it became necessary or desirable to secure the above mentioned loan in a substantial amount. There was, to be sure, less business activity than was shown in *Sheldon Building Corporation* v. *Commissioner of Internal Revenue*, 7 Cir., 118 F.2d 835, but we think enough did appear to make the principles applied in that case applicable to Raymep and that the decision of the Tax Court should be affirmed as to the taxability of that corporation. Compare, *Watson* v. *Commissioner of Internal Revenue*, 2 Cir., 124 F.2d 437; *Vim Securities Corporation* v *Commissioner of Internal Revenue*, 2 Cir., 130 F 2d 106, and *Palcar Real Estate Co.* v. *Commissioner of Internal Revenue*, 8 Cir., 131 F.2d 210.

Westrich, however, was at all times but a passive dummy which did nothing but take and hold the title to the real estate conveyed to it. It served no business purpose in connection with the property and was intended to serve only as a blind to deter the creditors of one of the partners. It was but a sham to be disregarded for tax purposes. *Gregory* v. *Helvering, supra.* See, also. *112 West 59th Street Corporation* v. *Helvering*, 62 App. D C. 350, 68 F.2d 397, and *North Jersey Title Ins. Co* v. *Commissioner of Internal Revenue*, 3 Cir., 84 F.2d 898.

Note

1. Can a corporation be a "passive dummy" one year and a taxable business entity the next?

2. Three wholly owned subsidiaries of the Air Reduction Corporation entered into

contracts with their parent providing that the subsidiaries were employed as agents to manage and operate designated manufacturing plants and to sell the output of these plants. The parent was to furnish working capital, executive management, and office facilities. The subsidiaries agreed to pay all profits to the parent except for six per cent on their outstanding capital stock, which was in each case nominal in amount. Title to the plants and related equipment was in the subsidiaries, but these assets were offset by loans payable to the parent. In *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949), the Supreme Court held that the entire operating profit, not merely the retained six per cent, was taxable to the subsidiaries, citing *Lucas* v. *Earl*, *supra*, p. 298, and related cases. The court went on

> What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent. (336 U.S. at 437.)

In *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590 (1943), a parent corporation was denied a deduction under § 162(a) for a payment to its wholly-owned subsidiary to defray the subsidiary's operating deficit for the taxable year, despite the fact that by contract it was entitled to the subsidiary's profits and was to reimburse the subsidiary for its losses. The Court held that the subsidiary's operating deficit was not an expense of the parent's business. The case was complicated by the fact that the subsidiary was organized to engage in operations (intrastate transportation in California) that were forbidden to the parent because it was a foreign corporation. The Court did not pass on the question of whether the parent's payments could be treated as an additional investment in the subsidiary to be recovered as a loss when the subsidiary was ultimately sold or liquidated.

3. See generally Cleary, "The Corporate Entity in Tax Cases," 1 *Tax Law Rev.* 3 (1945).

ALPROSA WATCH CORP. v. COMMISSIONER

Tax Court of the U.S., 1948

11 T.C 240

[The Swiss representative of an American partnership engaged in importing and selling Swiss watches bought on behalf of the partnership certain watches that the firm then found it was not able to import because of a competitor's exclusive franchise. The competitor agreed to permit the partnership to withdraw the watches, which as a result of war-time confusion had already been shipped to New York, from customs on condition that the partnership turn them over to some existing non-competitive organization, with the profits to be shared equally between the partnership and the competitor.

[The attorney for the partnership suggested that the firm purchase the stock of the Esspi Glove Corporation from an estate that he also represented. This corporation had been previously engaged in the manufacture of gloves, though it was authorized by its charter to buy, sell, and deal in all kinds of merchandise. The stock of the corporation was purchased by the partners' wives from the estate on

June 14, 1943, and two days later the corporation sold all of its assets (principally glove-manufacturing machinery) back to the estate. Thereafter its name was changed to Alprosa Watch Corporation, it acquired and sold the watches in question, and it continued in the jewelry business for three years.]

ARUNDELL, Judge The petitioner herein, the Alprosa Watch Corporation, which was engaged in the business of selling jewelry, including watches, during the period June 15 to June 30, 1943, claims the right to include in its returns for the fiscal year ended June 30, 1943, the income and losses realized by the Esspi Glove Corporation during the preceding portion of that fiscal year and in a prior year. Petitioner also seeks the benefit of the excess profits credits of the latter corporation. These claims are predicated on the theory that petitioner and Esspi are one and the same taxable entity, notwithstanding changes in the corporate name, stock ownership, business activity, and the location of the place of business.

Respondent takes the position that, while "technically the same corporate entity may have continued in existence," the benefit of the deductions and credits stemming from the prior activities of Esspi should be denied the petitioner. He argues that the control of Esspi was in fact acquired by the partners in the names of their wives "for the sole purpose of evading or avoiding federal taxes," that the whole transaction was unrealistic, served no business purpose, and should be rejected on the authority of *Gregory* v. *Helvering*, 293 U.S. 465, and *Higgins* v. *Smith*, 308 U.S. 473.

The cases relied on by respondent are landmark cases which have been regularly invoked to prohibit unreal uses of the corporate form to effect tax savings. Both cases involve transactions between corporations and their sole stockholders that were held to be unrealistic, tax-dodging devices, without substance or a legitimate business purpose. In both cases, the corporate entity used by the taxpayer as a vehicle of tax avoidance was disregarded for Federal tax purposes.

Under the theory upon which respondent has determined the deficiency in this proceeding, there is neither a corporation nor a transaction which we may "disregard" in determining the issue before us. Respondent submits that the "new corporation," Alprosa Watch Corporation, should be disregarded for Federal tax purposes—yet that corporation and not its stockholders or the partnership, is the taxpayer against which the respondent has found the deficiency. On the other hand, the transaction between the partnership and petitioner may not be disregarded, once it has been tacitly recognized by the finding of a deficiency against the petitioner based primarily upon the profits realized as a result of that transaction.

In addition, the facts in the instant case do not support a finding that the sole or principal purpose of the entire transaction was the evasion or avoidance of Federal taxes. We have found as a fact that the acquisition of an existing corporation was necessary if the Pierce watches were to be marketed, and, while we are satisfied that the parties in interest were not unaware of the tax advantages that might accrue through Esspi, the record does not support a finding that tax avoidance was the dominating motive.

A man's tax avoidance motives do not alone establish his liability. In *Chrisholm* v. *Commissioner*, 79 Fed.(2d) 14, it was stated:

> . . . In *Gregory* v. *Helvering*, *supra*, . . . the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught

the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.

It follows that the principles of *Gregory* v. *Helvering*, and *Higgins* v. *Smith*, are inapplicable.

It has been conceded by both parties that the provisions of § 129 of the Internal Revenue Code [§ 269, 1954 Code] are inapplicable, since the present case involves a taxable year beginning prior to December 31, 1943. However, it is respondent's suggestion that the legal principles set out in § 129 may well have been the law existing prior to the enactment of that section. Section 128(c) of the Revenue Act of 1943, which limits the significance of the date upon which the amendments made by § 129 were made effective, states in part:

. . . The determination of the law applicable to prior taxable years shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by this section is not expressly made applicable to prior taxable years.

The parties have not cited, nor have we been able to discover, any statement of law prior to the enactment of § 129 expressive of the specific principles set out in that section. There is considerable doubt in our minds that, even assuming that this case were to be governed by § 129, the facts constitute a situation condemned by that section. That section would seem to prohibit the use of a deduction, credit, or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired.

The remaining question in the case is whether Esspi and petitioner are actually the same corporate entity. In view of the established principle that a corporation and its stockholders are separate legal entities, it is recognized that a change in stock ownership does not produce a new corporate personality. *Erie Coca Cola Bottling Co.*, 1 B.T.A. 531; *East Coast Motors, Inc.*, 35 B.T.A. 212. In *Northway Securities Co.*, 23 B.T.A. 532, we held that the petitioner corporation was the same jural person as its so-called predecessor, notwithstanding a change in name, business situs, and type of business. *Cf. American Coast Line, Inc.* v. *Commissioner*, 159 Fed.(2d) 665.

In the case before us the corporate name was changed, the locus of business was immediately moved, the corporate stock was acquired by new owners, and the nature of the business was converted from the manufacture and sale of gloves to the purchase and sale of jewelry. The new business activity was authorized by the original certificate of incorporation. Furthermore, it is significant that no steps were taken to liquidate Esspi in the taxable year—in fact, petitioner conducted business for three years thereafter. In these circumstances, and on the authority of the cited cases, we hold that Esspi Glove Corporation and Alprosa Watch Corporation were the same corporate person for Federal tax purposes.

As it is our conclusion that the petitioner and the Esspi Glove Corporation constitute for Federal tax purposes one and the same taxpayer, it follows that petitioner may include in its corporate tax returns for the fiscal year ended June 30, 1943, the income and expenses of the Esspi Corporation for the period July 1, 1942, to

June 14, 1943, and is entitled to deduct the net operating losses of the latter company for its prior taxable year ended April 30, 1942. We hold further that petitioner is entitled to the use of the unused excess profits credits of the Esspi Glove Corporation in computing its excess profits credit for the taxable year ended June 30, 1943.

Note

1. Does the Tax Court's interpretation of § 269 conflict with the Treasury's view as expressed by example (1) in Regs. 118, Sec. 39.129-3(b)? See Tarleau, "Acquisition of Loss Companies," 31 *Taxes* 1050, 1054 (1953).

> Turning from the words of the statute, and of the Congressional committee report, to the *Alprosa Watch* dictum is indeed astounding. If the Tax Court is correct, Section 129 is practically meaningless . . . The *Alprosa Watch* dictum is flatly contrary to the intent of Congress in passing Section 129

2. An investor who contemplates the purchase of stock, whether of a public or a closely-held corporation, will presumably be influenced to some extent by the corporation's tax position of two corporations with equal future potential for profit-making, the one with a loss carryover will be more attractive.* Investor interest in corporate tax histories was especially marked when the excess profits tax was in effect, since this tax was applicable only when a corporation's earnings exceeded a putative normal rate based on either its earnings in the past or its invested capital. The corporation's tax history, then, is bound to have some effect on the price that will be paid for its shares See also the remarks of Mr. Justice Jackson, in *Western Pacific R.R Corp.* v. *Western Pacific R.R. Co*, *supra*, p. 370, suggesting that a tax loss is like any other corporate asset except for its restricted market. Moreover, if a corporation with either a loss in the early months of the taxable year or a loss carryover from previous years abandons its old line of business for more profitable activity, without any change in stock ownership, there would be no objection from the Commissioner to employing its losses to offset the income from its new activities. Why then should § 269 punish the sale of the stock of a loss corporation to other investors who can make use of its tax history, a transaction that may be the only way the old stockholders can recoup part of their lost investment?

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* Illustrations can be frequently found in the financial sections of the newspapers Even the sports pages take cognizance of this fact of life. The following is from the *New York Times* for November 3, 1953:

ORIOLES TO REBUILD CLUB WITH HELP OF INCOME TAX 'CARRY BACK' ON $500,000
Baltimore Gains by Brown Losses
Tidy Sum Above Tax Saving to be Spent for Players
Oriole President Says

The Orioles disclosed today that their purchase of the Browns included a provision that makes the first half million dollars of net income tax free and every cent will go toward rebuilding the American League team.

And that isn't all.

"Over and above that half million we have a very tidy and substantial figure to spend this year for new players," said Clarence W. Miles, president of the new Orioles.

"I'm 56 years old," he continued "I'd like to live long enough to win a pennant and a world series. I have only a few years left."

Miles told a luncheon of the Baltimore Sports Reporters Association that he was "letting his hair down" to them.

"We are blessed with one asset, the most important except for the franchise," he said "That's a tax carry-back"

He explained that the Browns had lost half a million dollars "which we can take as a loss. It means that Baltimore won't have to pay taxes to that extent."

All to Be 'Plowed Back'

He then promised that it all "will be plowed back into building up this ball club. No purchaser of a ball club ever enjoyed that before"

See generally Tarleau, *supra*; Rudick, "Acquisitions to Avoid Income or Excess Profits Tax Section 129 of the Internal Revenue Code," 58 *Harv. L. Rev* 196 (1944).

3. The 1954 Code introduced a new curb on the market in "loss" corporations· § 382 denies the operating loss carryover if there is a significant change in ownership (as defined) and if the corporation does not continue "to carry on a trade or business substantially the same" as before the change in ownership It should be noted that the bulk of the tax advantage in the *Alprosa Watch Corp.* came from losses in the part of the taxable year that preceded the change in ownership, rather than from the loss carryover from the previous year. Section 382 deals only with loss carryovers, moreover, it will not affect the corporation that has a "potential" tax loss, *e.g.*, because it owns property that has greatly depreciated in value.

The 1954 Code also added the presumption of § 269(c).

4. Woolford Realty Co. v. *Rose*, 286 U S 319 (1932), involved a consolidated return filed for 1927 by two affiliated corporations. One of the corporations had suffered losses in 1925 and 1926, before it became affiliated with the other, it suffered an additional loss in 1927, after affiliation. The other corporation had substantial profits in 1927. The Supreme Court upheld the Commissioner's determination that the pre-affiliation losses could not be carried forward and used in computing the 1927 consolidated income.

> A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious. (286 U.S. at 329-339.)

Pre-affiliation losses can be carried forward and used, however, to offset such part of the consolidated income as is produced by the corporation that experienced the losses. Regs. 129, Sec. 24(b)(3)

It will be noted that in the *Woolford Realty Co.* case, the newcomer's *1927* loss was allowed to offset the other corporation's income In *J. D. & A. B. Spreckels Co.* v. *Commissioner*, 41 B T.A. 370 (1940), however, such a post-affiliation loss was disallowed on the consolidated return, upon a showing that the loss was anticipated when the corporation was acquired and that the only purpose of the acquisition was to take advantage of the expected loss by filing a consolidated return. Note the relation between this holding and § 269.

Even if tax avoidance is not the purpose of the acquisition, the consolidated return regulations now provide that certain losses of a newly acquired corporation (*e.g*, those incurred on the sale of capital assets or of § 1033 property) can be used to offset only its own portion of the consolidated income, except to the extent that the losses are attributable to events occurring after affiliation. Regs. 129, Sec. 29 31(b)(11)(ii); Hellerstein, "Consolidated Federal Income Tax Returns," 5 *Amer. U. Tax Inst. Lectures* 415, 448-51 (1953).

Section C. Creating the Corporation

> ***Note:*** **Section 351 of the 1954 Code, governing transfers to controlled corporations, carries forward the basic principle of § 112(b)(5) of the 1939 Code.**
>
> **Section 368(c) of the 1954 Code, defining "control," is identical with § 112(h) of the 1939 Code.**
>
> **Sections 358 and 362, governing the basis of property acquired on an exchange, are based on §§ 113(a)(6) and 113(a)(8) of the 1939 Code.**

If Jones organizes a new corporation, Jones, Inc., paying cash for its shares, neither he nor the corporation realizes income on the transaction. Jones has done

no more than to buy property (a capital asset, unless he is a security dealer buying for resale), and the corporation on original issue of its stock is not regarded as selling or exchanging property or as otherwise realizing income * The par value, if any, of the shares is irrelevant. See Regs 118, Sec. 39.22(a)-15. The tax consequences would be no different if Jones, Inc were being organized not by a single individual but by the Jones Holding Co., Inc., or by Thomas, Richard, and Harold.

But suppose that Jones owns a business, now operated as an individual proprietorship, and that he proposes to transfer it to a newly organized corporation, Jones, Inc., in return for all of the stock of the new entity The regulation just cited will prevent the corporation from realizing gain or loss. What of Jones? He has transferred property—his business or its constituent assets—for other property, *viz.*, the Jones Inc. stock. We have noted before that on a sale or exchange, the transferor realizes gain or loss if the value of the property received either exceeds or is less than the adjusted basis of the property given up, § 1001, and that the entire amount of the realized gain or loss must be recognized unless some statutory exception is applicable, § 1002. Since 1921, a statutory exception—§ 112(b)(5) of the 1939 Code, now § 351 of the 1954 Code—has provided for the non-recognition of gain or loss on most incorporations. Where this non-recognition provision is inapplicable, any gain or loss must be recognized, just as under the pre-1921 statute gain or loss realized on the creation of *any* corporation had to be recognized. *Livingston v. Commissioner*, 18 B.T.A. 1184 (1930).

In the simple, but common, situation just suggested, § 351 will apply and Jones will report neither gain nor loss on the exchange. In accordance with the usual rule, however, non-recognition of gain or loss requires the old basis (of the property given up) to be carried over and applied to the property received on the exchange See § 358(a). In the interest of simplicity, it is assumed that Jones got nothing but stock and that the corporation did not assume, or take property subject to, any liabilities.

If Jones sells the stock at a later date, he will (assuming no change in values) recognize his postponed gain or loss then † The stock will be a capital asset, however, whereas the unincorporated business was not a united item of property but a conglomeration of assets, some capital (*e.g.*, good will), some non-capital (*e.g.*, inventory), some quasi-capital (*i.e.*, subject to § 1231, like real estate, machinery and fixtures). *Williams v. McGowan*, *supra*, p. 436

If the incorporation of a business does not comply with § 351, gain or loss will be recognized on the exchange, and the basis of the stock will be its "cost," *i.e.*, the value of the property given in exchange for it. Since, therefore, the basis of stock received when a business or other appreciated or depreciated assets are trans-

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* Until 1954, if the corporation at a later date bought back some of its own stock and then reissued it, it might realize profit or loss if the reissue price was more or less than the price it paid on reacquiring the stock. See Murphy, 'How To Handle Treasury Stock, Distinction Between Treasury Stock and Unissued Stock Is there Any Justification for This?' *10th Annual N.Y.U Inst. on Fed Taxation* 1161 (1952), Anderson, "Gain Or Loss to a Corporation Dealing in Its Own Shares," 1953 *So Calif. Tax Inst* 121

Section 1032 of the 1954 Code provides that no gain or loss shall be recognized by the corporation in these circumstances

† If the stock is held until death, however, Jones heirs will get a basic equal to its value at the date of death, by reason of § 1014

ferred to a corporation depends upon whether the exchange was taxable when made, the applicability of § 351 may come into question not only when the corporation is organized but also many years later, when the stock is sold.

Our man Jones is not the only one who must worry about a preservation of the old basis. Section 362(a) provides that if the transfer to the corporation was a tax-free exchange, the *corporation's* basis for the assets transferred to it shall be the basis they had in the hands of Jones. It has been held that the transferee corporation steps into the shoes of the transferor so that the total old basis is allocated among the various assets in the same way as when they were held by the transferor, rather than being re-allocated in proportion to market values at the time of the transfer. *Birren* v. *Commissioner,* 116 F.2d 718 (7th Cir. 1940).

Why this dual preservation of the old basis? Could tax avoidance result if only one of the parties retained the old basis, the other getting a basis equal to market value? Can inequity be produced by the existing statutory scheme?

FAHS v. FLORIDA MACHINE & FOUNDRY CO.

U.S. Court of Appeals, Fifth Circuit, 1948
168 F.2d 957

Before HUTCHESON, HOLMES, and MCCORD, Circuit Judges.

MCCORD, Circuit Judge.

Appellee, Florida Machine and Foundry Company, filed suit to recover additional income and excess profits taxes, aggregating $19,089.44, paid for the years 1941 and 1942 under protest. From a judgment for appellee taxpayer, the Collector takes this appeal.

The only question presented is the proper cost basis to be used by taxpayer in computing gain or loss on the sale of certain land it owned in 1941, and in determining taxpayer's equity invested capital [for computing excess profits tax] for the years 1941 and 1942.

Title 26 U.S.C.A. Int. Rev. Code, § 112(b)(5), provides

> Sec. 112. Recognition of gain or loss— . . .
> (b) Exchanges solely in kind— . . .
> (5) Transfer to corporation controlled by transferor.
> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; . . .

Section 112(h) defines the term "control," as used in the above quoted provision, as follows:

> . . . . Definition of control As used in this section the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. . . .

Section 718(a) (2) of the Code requires that property paid in for stock be included in equity invested capital in the amount of its basis for determining loss upon sale or exchange. The basis to be used for property acquired by a corporation after December 31, 1920, through the issuance of its stock for property in accordance with Section 112(b) (5), above, is the same as it would be in the

hands of the transferor. Section 113(a) (8), Internal Revenue Code. If, however, the issuance of the stock for property is not governed by Section 112(b) (5), the taxpayer's basis is the cost to it of such property, or the fair market value of the property on the date of acquisition. Section 113(a).

The evidence reveals that for some years prior to 1912, Franklin G Russell, Senior, as sole owner, operated a business known as Florida Machine Works on Riverside Avenue in Jacksonville, Florida. On May 31, 1912, he purchased a tract of land bordering on West Church Street in Jacksonville, to which location the plant was later moved.

About the year 1920, it was shown that the Senior Mr. Russell, who had little technical education for foundry and machine shop work, discussed with his son, Franklin G. Russell, Junior, the possibility of the son eventually succeeding him in the business. The son had graduated from college in 1916 with a degree in mechanical enginering and, with the exception of about two years spent as a soldier in World War I, had served since that time as an apprentice in the various departments of his father's plant, later becoming assistant manager. When the location of the business was changed from Riverside Avenue to West Church Street, the son himself had planned and laid out the new plant installations. In 1921 the father and son entered into an agreement whereby the son would eventually receive a one-half interest in the business, if he remained with it and continued to operate the plant In pursuance of this agreement, the Florida Machine and Foundry Company, taxpayer, was organized and incorporated on July 16, 1924. At the organization meeting on that date, the Senior Russell conveyed to the corporation all of the assets of the business which he then owned individually, including the tract of land in question, for stock in the corporation, with the shares thereof to be issued directly to himself, his son, and one share each to three other persons. The father received 1181 shares and his son 1176 shares, the father thereby retaining only a bare majority of the stock issued.

In 1941, the corporation sold a parcel of the land on West Church Street for $15,000. The March 1, 1913, value of this tract was $7,522.60. On July 16, 1924, the date taxpayer corporation was organized, the fair market value of the tract sold was $13,164.55.

In its 1941 return, the taxpayer claimed a loss on the above sale in the sum of $11,270, using as its basis of value for the land sold, the amount of $26,270,* which was the proportionate fair market value of the land sold as compared with the fair market value of the entire tract as of July 16, 1924, the date of organization of the corporation and acquisition of the land by taxpayer. The Commissioner denied the validity of the basis used, on the ground that the transfer to the corporation on July 16, 1924, was really a non-taxable exchange of property for stock, as described in § 112(b) (5) of the Code, and ruled that, for the purpose of computing taxpayer's gain or loss under § 113(a) (8), the proper basis of value was the March 1, 1913 value in the hands of the transferor, Franklin G. Russell, Senior, or $7,824.53, so that instead of a loss of $11,270 as claimed by taxpayer, there was a taxable gain of $7,175 47; he further required the use of

* The District Court, while it accepted the taxpayer's contention that the 1924 value was controlling, found that value to be $13,164.55, rather than $26,270 as claimed by the taxpayer. [Ed.]

the same basis in computing taxpayer's equity invested capital under § 718(a) (2), for the years 1941 and 1942.

We are of opinion the district court's finding that Franklin Russell, Senior, was not in "control" of taxpayer corporation "immediately after the transfer" on July 16, 1924, and therefore, that § 112(b) (5) did not apply, is abundantly supported by the evidence.[1] 26 U.S.C.A. Int. Rev. Code, §§ 112(b) (5), 112(h); *Heberlein* v. *U.S.*, 2 Cir., 105 F.2d 965; *Bassick* v. *Commissioner*, 2 Cir., 85 F.2d 8, *Hazeltine Corporation* v. *Commissioner*, 3 Cir., 89 F.2d 513.

Appellant's contention that the son, Franklin Russell, Junior, by virtue of the agreement with his father in 1921, acquired an equitable one-half interest in the land involved, which thereafter placed him and his father, as joint transferors, in "control" of taxpayer immediately after the transfer, is not borne out by the evidence. We further find no merit in the argument that taxpayer should be required to use the basis of its transferor, Franklin G. Russell, Senior, because of the latter's failure to report the transfer in 1924. There can be no estoppel against taxpayer for the act of its transferor, who was not in control of taxpayer corporation immediately after the transfer, and who was shown to have acted in good faith. *Cf. Portland Oil Co.* v. *Commissioner*, 1 Cir., 109 F.2d 479; *Orange Securities Corporation* v. *Commissioner*, 5 Cir., 131 F.2d 662.

It follows that the proper basis for the land in question is its fair market value when acquired by taxpayer corporation on July 16, 1924.

We find no reversible error in the record, and the judgment is therefore affirmed.

Note

1. Wilgard Realty Co. v. *Commissioner*, 127 F.2d 514 (2d Cir.), cert. den. 317 U.S. 655 (1942), involved a transfer of appreciated property by an individual to a corporation in exchange for all its stock. Immediately after the stock was issued to him, he transferred more than 20 per cent of it by gift to members of his family. On a later sale of the transferred property, the corporation claimed a stepped-up basis on the ground that the incorporation fell outside of § 351. The Court held that the transfer was non-taxable.

> Though it was plainly enough [the transferor's] intention to create the petitioner [corporation] . . . in order to provide him with stock to give as he did to his relatives, he was under no obligation to make the gift. There is neither claim nor proof that he was bound to carry out his intention to give any of it away when he received the stock or that he was not free at any time up to the very moment he gave it away to change his mind and use it for any lawful purpose. . . .

[1] The district court found:

". . Obviously, Mr. Russell, Senior, owned far less than 80% of taxpayer's capital stock according to the stock register. There is no basis in the evidence to find that the issue of stock on July 16, 1924, and the interests in the corporation thereby represented, were other than bona fide There is no evidence of subterfuge or evasion,—no evidence that Mr. Russell sought to conceal a personal control of the corporation by formally placing one-half of the capital stock in his son's name. To the contrary, it appears that the entire transaction was regular and in good faith, for the declared purpose of bringing his son into the business as a one-half owner, so that the son could and would carry on this long-standing family business after the retirement of his father, who was then getting along in years. At the time of this transaction, the son was a mature and experienced man, 31 years old, fully competent by education and experience to take over and manage the responsibilities of the business, which he did. The uncontradicted evidence is that the son was the absolute owner of the stock issued to him; that he exercised all the privileges of ownership thereof, and paid income tax on the dividends therefrom. . . ."

In the absence of any restriction upon his freedom of action after he acquired the stock, he had 'immediately after the exchange' as much control of the petitioner as if he had not before made up his mind to give away most of his stock and with it consequently his control. (127 F.2d at 516.)

For the effect of an underwriting arrangement by which part or all of the stock received by the transferor is to be sold after the incorporation, see *American Bantam Car Co.* v. *Commissioner*, 11 T.C. 397 (1948), aff'd p.c. 177 F.2d 513 (3d Cir. 1949); see also *May Broadcasting* v. *United States*, 200 F 2d 852 (8th Cir 1953); *National Bellas Hess, Inc.* v. *Commissioner*, 20 T C. 636 (1953).

Does the "special rule" of § 351(c), which is new in the 1954 Code, suggest that fleeting control is insufficient in those instances where the special rule is inapplicable?

See Mintz, "Step Transactions in Corporate Reorganizations," 12th *Annual N.Y.U Inst. on Fed. Taxation* 247 (1954).

2. As to the issue of estoppel, is the court's holding realistic? Is either the transferor, Franklin G. Russell, Sr., or his son, estopped to claim a "stepped-up" basis for his stock? The student should at this point probe into the murky recesses of §§ 1311-15, which provide a partial antidote to inconsistency by either the taxpayer or Commissioner. How does this statutory approach differ from the doctrine of estoppel? Note the limitation of § 1314(d). See also Regs. 118, Sec. 39.3801(b)-5, Example (1). Section 3801, the predecessor of these sections, is thoroughly considered in Maguire, Surrey, and Traynor, "Section 820 of the Revenue Act of 1938," 48 *Yale L. J.* 509, 719 (1939). In *Orange Securities Corporation* v. *Commissioner*, 131 F.2d 662 (5th Cir. 1942), the corporation was denied a stepped-up basis on grounds of estoppel, Section 3801 was not mentioned.

See *infra*, pp. 758-770.

3. Section 351(a) provides for non-recognition of gain or loss only if property is transferred to a corporation "*solely* in exchange for stock or securities in such corporation." What if all other requirements are met, but the transferor receives some cash or other property "to boot"? This could occur, for example, if the transferee, either an existing corporation with cash on hand or a newly organized corporation which received property from one stockholder and cash from another, gave a transferor of property some cash as well as securities. Section 351(b) provides that the receipt of other property or money (often known as "boot") results in the *pro tanto* recognition by the transferor of whatever gain is realized on the transfer. The reason is that to the extent of the "boot" the transferor has changed his investment in substance as well as in form, the "boot" does not represent a continuing interest in the transferred property, as do stocks or other securities of the transferee corporation. In return for the recognition of gain on the receipt of "boot," § 358 permits the transferor to adjust the basis of his securities upward, and § 362(a) provides for a similar upward adjustment of the property received by the corporation.

It should be noted that where depreciated, rather than appreciated, property is transferred to a corporation, the receipt of "boot" does not take the transaction out of § 351 so as to permit the recognition of loss. See § 351(b). Of course, if the transaction is outside of § 351 for some reason other than the receipt of "boot," loss can be recognized under the general rule of § 1002. But recall that a loss cannot be taken on sales or exchanges between certain related persons Section 267; *Commissioner* v. *Whitney*, 169 F.2d 562 (2d Cir. 1948).

4. Section 351 has dropped a requirement contained in its predecessor, § 112(b)(5) of the 1939 Code, that "in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." The clause gave rise to difficult questions of valuation, as well as to conflicting opinions on how the proportion of change was to be calculated and on what constituted a "substantial" change. See Hoffman, "The Substantial Proportionment Requirement of Section 112(b)(5)," 5 *Tax Law Rev.* 235 (1950). Moreover, the purpose of the requirement was quite obscure. Under it, a reshuffling of the interests of the trans-

ferors could throw an exchange outside of the tax-free provision, and this would mean that gain or loss on the creation of the corporation would be fully recognized in amounts that might bear no relationship at all to the gain or loss resulting from the reshuffling itself. For example, if *A* transferred property worth $100,000 and *B* property worth $50,000, and in exchange stock worth $80,000 was issued to *A* and stock worth $70,000 was issued to *B*, the "substantially in proportion" test would not be met. (Under one interpretation, an even less drastic change would violate the clause). The exchange would then be fully taxable. If *A*'s property had an adjusted basis of $25,000 and *B's* an adjusted basis of $150,000, the result would apparently be a gain to *A* of $55,000 and a loss to *B* of $80,000, despite the fact that the change in interests at the time of the exchange caused a loss to *A* and gain to *B*

In abandoning the "substantially in proportion" requirement, the new Code points out that an exchange may have the effect of a gift or of the payment of compensation. §§ 351(d)(3) and (4). The Senate Report states (pp. 264-5):

> To the extent . . . that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature. . . . In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind

What is the relation of the second sentence of § 351(a) to the foregoing? Suppose one person transfers property and another does not, but each gets 50% of the stock. Has the control requirement, see § 368(c), been met?

The "substantially in proportion" requirement may be gone, but it cannot be forgotten. In the case of exchanges before the 1954 Code became effective, the basis of property will be governd by the old law. § 1052(c). Note how long a period of time elapsed between the incorporation and the litigation in the *Florida Machine & Foundry Co.* case. Another important case in this area, *Mather & Co.* v. *Commissioner*, 171 F.2d 864 (3d Cir 1949), cert. den. 337 U.S. 907, involved an exchange in 1926 and a sale in 1942 of property acquired on the exchange.

5. Suppose a dozen independent grocers transfer their separate businesses to a newly organized corporation, each taking common stock in proportion to the present value of the property transferred by him. Is this transaction within § 351?

Can one transferor take back common stock and the others nothing but preferred stock or bonds?

6. The term "securities" as used in § 351 is not defined In view of the tax treatment of "boot," it is reasonable to assume that short-term notes and similar instruments will be treated as the equivalent of cash or other property rather than as "securities." This possibility is not examined further here, since the term "securities" has been the subject of important judicial explanation under the tax-free reorganization sections, but it should be borne in mind. See *infra*, p. 566 Instruments of long-term debt are clearly "securities" and may be received tax-free. If non-recognition is granted because the taxpayer has changed his investment in form only, should all debt be treated as "boot," leaving only common and preferred stock for tax-free receipt?

7. If the corporation at the time of the exchange assumes an indebtedness of the transferor, he receives a benefit that may be the equivalent of "boot." The parallel is particularly pronounced if the transferor mortgages the property just before the exchange, keeps the cash thus raised, and then transfers the property for stock plus an assumption of the mortgage. In these circumstances he may be as well off as though he had received cash as "boot" from the corporation itself. In *United States* v. *Hendler*, 303 U.S. 564 (1938), it was held (under the somewhat parallel reorganization sections) that an assumption of the transferor's indebtedness constituted "boot." Besides promising future inconvenience, since virtually all incorporations of existing businesses and reorganizations include an assumption of liabilities, the decision threatened to confer stepped-up bases on both transferor and transferee in countless past

transactions assumed to be tax-free when consummated The Treasury, not sure whether the defense of estoppel would prevent the claims of stepped-up basis, hastened to relinquish its victory. §§ 357(a) and (b), substantially the same as § 112(k) of the 1939 Code, are the result. See Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 *Yale L. J.* 1 (1940).

Assuming or taking subject to debt is treated as "boot" only in limited instances. Why then does such a transaction always require a downward adjustment of basis under §§ 358(a) and (d)?

Section 357(c) is new in the 1954 Code. What is its purpose?

Section D. The Corporation's Capital Structure

Since interest is deductible while dividends are not, there is an obvious tax incentive to having a corporation issue evidences of indebtedness as well as stock for the cash or property transferred to it by its stockholders. Moreover, certain personal tax advantages will accrue to the organizers of the corporation, if they become creditors as well as stockholders of the corporation. If the corporation prospers, it may pay off its debt and the creditor-stockholders will realize income only to the extent that the payment exceeds the "adjusted basis" of the instruments paid off * The income, if any, will be capital gain under § 1232.

If the organizers hold only stock, however, the entire amount of any payment by the corporation (including a *pro rata* reacquisition of stock) would probably be taxed as a dividend, *i.e.*, as ordinary income. See *infra*, p. 495.

On the other hand, if the corporation should fail, the creditor-stockholder has at least a fighting chance to write off his loss on the worthless debt against ordinary income. Such a deduction will be permissible if §§ 166(d) and (e) are not applicable, *i.e.*, if the debt is not evidenced by a "security" and if it is not a "nonbusiness bad debt," see the *Smith* case, *supra*, p. 257. Loss on worthless stock, however, must be treated as a capital loss, § 165(g), unless § 165(g) (3) is applicable.

Some of the other ways in which corporate debt is encouraged by the Internal Revenue Code will be encountered later in this book. For a study of the economic effect of these tax incentives, see Lent, "Bond Interest Deduction and the Federal Corporation Income Tax," 2 *Nat'l Tax J.* 131 (1949).

In an effort to exploit the tax advantages enjoyed by debt, taxpayers have on occasion gone too far and thereby lost out:

(a) Where the corporation is not able to issue ordinary evidences of indebtedness, usually because of a fear of clogging its credit position, there have been attempts to get the same tax effect by issuing "hybrid" securities. These instruments look like preferred stock to creditors, but it is hoped that they will pass muster as bonds, debentures, or notes before the tax collector. Among the characteristics of such "hybrid" securities are the following: (1) they are held by the same persons and in the same proportions as the stock; (2) they are transferable only with stock; (3) they have far-off maturities, or no maturity dates; (4) the

* In this connection, § 358 should be reexamined. Suppose assets with an adjusted basis of $60,000 and a market value of $150,000 are transferred to a newly organized corporation for 1000 shares of common stock without par value plus bonds of a total face amount of $50,000. What is the basis of the bonds? Would the result be different if the stock had a par value?

"interest" is geared to income or is discretionary with the directors; (5) payment of the "interest" or "principal" (or both) is subordinated to general creditors, and (6) they are issued only to stockholders and not for new consideration.

If too many of these features are found, the instruments will be treated as preferred stock rather than as evidences of indebtedness.† The leading case on the subject is *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946). Suppose an instrument is labelled preferred stock, but has all the other indicia of a bond. Can the issuing corporation deduct the "dividends" on the ground that they constitute interest on indebtedness? The deduction has occasionally been permitted. *United States* v. *Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943); *Choctaw, Inc.* v. *Commissioner*, ¶ 53,397 P-H Memo TC. In the former case the misleading label was employed to avoid recognition of debt on the issuer's balance sheet; in the latter case, it was apparently intended to give the investor an opportunity to claim the dividends received credit granted to corporate stockholders by § 26(b) (1) of the 1939 Code. (This allowance, which is now a deduction, is carried over by § 243 of the 1954 Code.)

(b) At the opposite extreme are the corporations that are so unconcerned about their credit standing that they can issue seemingly orthodox debt securities in an amount that overwhelms the common stock investment, *e.g.*, bonds in the amount of $99,000 plus common stock against assets valued at $100,000. Here the problem is that the bonds, although containing iron-clad indicia of debt, may be treated as the equivalent of stock for tax purposes because anyone buying such instruments would regard himself, in the light of the corporation's trivial equity, as a stockholder or potential stockholder and not as a bondholder. An obvious parallel is the bankruptcy treatment of stockholder advances as capital contributions rather than as loans where the corporation was inadequately capitalized. See *Dobkin* v. *Commissioner*, 15 T.C. 31 (1950); aff'd p.c. 192 F.2d 392 (2d Cir. 1951); Schlesinger, " 'Thin' Incorporations. Income Tax Advantages and Pitfalls," 61 *Harv. L. Rev.* 50 (1947); Semmel, "Loan Versus Investment—Inadequate Capitalization," 5 *Tax L. Rev.* 424 (1950).

(c) If the bonds were issued by a subsidiary corporation to its parent, a recent Tax Court case suggests that they might be treated as the equivalent of stock because of a lack of bona fide intent to create a debtor-creditor relationship, even though the bonds on their face have all the indicia of debt instruments and even though the subsidiary is not under-capitalized. *Kraft Foods Co.* v. *Commissioner*, 21 T.C. No. 63 (1954).

The credit for dividends received by individuals that is granted by § 34 of the 1954 Code may reduce to some degree the pressure on corporations to take advantage of the deduction for interest paid on indebtedness. Will the total tax savings to a closely-held group from the dividends received credit match the savings that can be achieved by the use of corporate debt? In some instances, we may find the corporation claiming that it paid "interest" while the stockholders argue that they received "dividends."

† The House version of the 1954 Code contained definitions designed to indicate precisely what instruments would qualify for the interest deduction and for other tax privileges. But the Senate dropped these definitions, stating (S. Rept. p. 42) "Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments."

The foregoing discussion has focused upon loans, or purported loans, with respect to which the corporation issued evidences of indebtedness. Stockholders often advance funds or transfer property to their corporations, however, without receiving any stock or securities in return and without making clear whether the advances are loans to the corporations or capital contributions. If an ambiguous advance is interpreted as a capital contribution, it increases the stockholder's basis for his stock. Any return paid thereon would be a non-deductible distribution by the corporation rather than interest on a loan, and if the corporation suffered financial reverses, the loss would be written off with the stock becoming worthless. The stockholder would have a capital loss under § 165(g), unless § 165 (g) (3) is applicable.

On the other hand, if the advance is found to be a loan by the stockholder to his corporation, payment for the use of the money or property advanced would be interest, deductible by the corporation. Moreover, if the obligation becomes worthless, it can be written off as a bad debt in the year of worthlessness under § 166. The loan might prove to be worthless in a different year than that in which the stock becomes worthless; and under some circumstances a partial write-off would be in order. The bad debt will give rise to an ordinary or a capital loss, depending upon whether it is a business or a non-business bad debt. See *supra*, p. 257.

See generally Holland, "Tax Effects of Stockholder Loans to Corporations," *9th Annual N.Y.U. Inst. on Fed. Taxation* 1083 (1951).

Section E. Distributions of Earnings by the Going Concern

Note: Section 316(a) of the 1954 Code, defining the term "dividend," is substantially the same as §§ 115(a) and 115(b) of the 1939 Code.

Section 301(c), prescribing how corporate distributions shall be taxed, is substantially the same as §§ 22(e), 115(b), and 115(d) of the 1939 Code.

See Regs. 118, Sec. 39.115(a)-2.

1. "Earnings and Profits"

Section 316(a) provides that any distribution either from earnings and profits accumulated after February 28, 1913 or from earnings and profits of the current year is a "dividend." Sections 61(a)(7) and 301(c)(1) provide that "dividends" shall be included in gross income. Any corporate distribution that is not a "dividend" — as that term is defined by § 316 — is received tax-free but must be applied in reduction of the basis of the stock on which it is distributed. § 301(c)(2). Once the stockholder has recovered his basis, non-dividend distributions are ordinarily taxed as capital gains. § 301(c)(3)(A). If the non-dividend distribution consists of an increase in the value of corporate property that accrued before March 1, 1913 (even though realized thereafter by sale or otherwise), however, it is applied in reduction of the stockholder's basis for his stock in the same way as other non-dividend distributions, but any excess is not taxed. Section 301(c)(3) (B) codifies existing law; see *Higginson* v. *United States*, 81 F. Supp. 254 (Ct.Cl. 1948); *Blauvelt* v. *Commissioner*, 4 T.C. 10 (1944).

If we assume a corporation newly organized for cash, the reason for gearing the taxability of its distributions to its record of earnings and profits is clear enough. Until the corporation has engaged in profitable operations, any distribution to its original stockholders is a return of their investment rather than income. Once the corporation has realized profits, on the other hand, its distributions may *pro tanto* be fairly regarded as income to the stockholders.

The equity of §§ 316 and 301(c) is far less clear if we assume that after a period of corporate profits the stock changes hands and that before additional earnings arise (the next day, if you will) there is a distribution to the new stockholder. Has not *he* received a return of *his* capital? Sections 316 and 301(c) are inescapable, however, and to the extent of his share of the earnings and profits the surprised stockholder has realized income This "miracle of income without gain" —the phrase is from Powell, "Income from Corporate Dividends," 35 *Harv. L. Rev.* 363 (1922)—long ago was attested by the Supreme Court in *United States* v. *Phellis*, 257 U.S. 156, 171–2 (1921).

Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he was called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon.

How accurately can the purchaser tailor the price he offers for a share of stock to fit the income tax liability he will incur if a dividend is declared?

Whatever argument of equity may be urged against *United States* v. *Phellis*, it would no doubt be administratively unfeasible to tax each individual stockholder on dividends only to the extent that his corporation had had earnings after he purchased his shares. This suggests the question. if we can stomach the inequity arising in thousands of *Phellis* transactions, is there any reason for tying the taxation of corporate distributions to earnings and profits at all?

It is a curious fact that the Code, ordinarily so prodigal in the use of words, nowhere defines the term "earnings and profits," although the term has no counterpart in the field of corporation law. The term is partly explained by Regs. 118, Sec. 39.115(a)-2, and the effect of a few transactions on earnings and profits is prescribed by the Code. See § 312 and 381(c)(2). See also the exhaustive discussion by Rudick, " 'Dividends' and 'Earnings or Profits' Under the Income Tax Law: Corporate Non-Liquidating Distributions," 89 *U. of Pa. L. Rev.* 865 (1941). Mr. Rudick's article is brought up to date by Albrecht, " 'Dividends' and 'Earnings or Profits'," 7 *Tax L. Rev.* 157 (1952); and see *Diebold* v. *Commissioner*, ¶ 53,052 P-H Memo TC. The determination of earnings and profits is often no simple feat, especially when they must be traced through a series of corporate reorganizations or similar transactions. It may be necessary to go back many years to decide

how a transaction should have been taxed under a now interred statute because of its effect upon earnings and profits.

See § 312(j), adopted in 1954 to insure that shareholders will be taxed at ordinary income rates on corporate distributions of "excess" mortgage proceeds when the loan is guaranteed by the United States under the F.H.A. and similar programs. Previously it had been assumed that such distributions were taxable only as capital gain and only to the extent they exceeded the basis of the stock. Litigation in the Tax Court in regard to pre-1954 loans is now pending and is unaffected by the enactment of § 312(j).

Two more aspects of earnings and profits should be noted.

(1) If a corporation has earnings and profits *in the taxable year*, any distribution will be taxable *pro tanto*, even though the corporation has a deficit. Section 316 (a)(2). This provision has a curious ancestry. It was enacted in 1936 as a relief measure when the undistributed profits tax was in effect. That tax was imposed on the undistributed part of corporate income, computed by deducting "dividends" from total income. Unless a deficit corporation could treat distributions out of current earnings as "dividends" for this purpose, it would be unable to avoid the undistributed profits tax no matter how large its distributions to stockholders were. To enable such corporations to obtain a credit for "dividends" paid out of current earnings, § 316(a)(2) was enacted * Apparently no thought was given to the effect of the new subsection apart from the undistributed profits tax. Its impact can sometimes be avoided by postponing the distribution until the next year. If the corporation has no earnings in that year and still has a deficit, the distribution will be receivable tax-free since it will fall under neither § 316(a)(1) nor § 316(a)(2).

(2) Note the importance in this area of March 1, 1913, the date on which the Revenue Act of 1913 (the first federal income tax imposed after the Sixteenth Amendment was adopted) became effective. Earnings and profits accumulated before this date are not included in gross income, but they are applied to reduce the basis of the stock on which they are distributed, and (as pointed out above) any excess is ordinarily taxed as capital gain. Post-1913 earnings and profits must be distributed first, as a result of the second sentence of § 316(a); "earmarking" is not permissible.

These pre-1913 sources do not enjoy constitutional immunity from tax, *Lynch v. Hornby*, 247 U.S. 339 (1918), but Treasury attempts to obtain a repeal of the privilege have been defeated. See House Ways and Means Committee, 77th Cong., 2d sess., Hearings on Revenue Revision of 1942, pp. 1692ff; H. Rept. No. 2319, 81st Cong., 2d sess., reprinted in 50-2 C.B. 380, 418-9, estimating that revenues would be increased about $1 million annually by removing the immunity of pre-1913 earnings and increase in value.

Note should also be taken of the deduction granted by § 243 for dividends received by one corporation from another. Suppose a corporation pays $110,000 for all the stock of another corporation that has $100,000 of earnings and profits. The acquired corporation then declares and pays a dividend of $100,000, and

* A 1942 amendment provided retroactive relief for deficit corporations that had been taxed on their undistributed profits even though prohibited by state law from paying dividends § 501(a)(2), Revenue Act of 1942, 56 Stat. 798, 954. See *United States v. Oglivie Hardware Co.*, 330 U.S. 709 (1947); *Hamilton Mfg. Co. v. United States* — F.2d — (7th Cir. 1954).

after receiving the dividend the parent corporation sells the subsidiary for $10,000. Does the parent have a capital loss of $100,000 on the sale of the stock and only $15,000 of ordinary income (*i.e.*, $100,000 less the 85 per cent deduction) on the dividend?

When a consolidated return is filed, intra-system dividends are not taxed; dividends from outside the affiliated group are still taxable, but the 85 per cent deduction is available with respect to them. *Supra*, p. 370.

BANGOR & AROOSTOOK R.R. CO v. COMMISSIONER

Tax Court of the U.S., 1951
16 T.C. 578

RAUM, Judge. In 1942 petitioner repurchased its own bonds, paying $497,553.30 for bonds of the face amount of $634,000, and realized a taxable gain of $136,446.70. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1, *Commissioner* v. *Jacobson*, 336 U.S. 28; *Spear Box Co.* v. *Commissioner*, 182 Fed.(2d) 844 (C.A. 2). It elected, however, to take advantage of a statutory option under which the gain was excluded from its 1942 gross income, and, instead, the gain was applied in reduction of the basis of property held by petitioner Section 22(b)(9) and 113(b)(3) [now, somewhat modified, §§ 108 and 1017 of the 1954 Code].

Thereafter, in calculating its excess profits tax liability for 1943, petitioner used the invested capital method for computing its excess profits credit. Part of that credit consisted of its "accumulated earnings and profits" as of the beginning of 1943. Petitioner included its 1942 bond profit in its accumulated earnings and profits as of the beginning of 1943. Respondent, however, excluded that bond profit from petitioner's accumulated earnings and profits and, with the resulting reduction in petitioner's excess profits credit, found a deficiency. This proceeding was brought to review that determination of deficiency.

The concept of "earnings and profits" has been an important part of Federal tax legislation for many years, being employed for income tax purposes to identify the source of taxable corporate dividends. Section 115(l) of the Internal Revenue Code, which was added by section 501 of the Second Revenue Act of 1940, was the first attempt by Congress to deal with the meaning of the concept, prior thereto its intended scope was developed by judicial and administrative construction. See *Commissioner* v. *Wheeler*, 324 U.S. 542, 545. Moreover, section 115(l) deals with "earnings and profits" only in certain particulars; it makes no attempt to furnish a comprehensive definition of the term.*. . .

Section 115(l) is literally not applicable here. By its terms, it deals with the effect on "earnings and profits" of certain corporate distributions and of "gain or loss realized from the sale or other disposition of property." We have before us neither a corporate distribution nor a sale or other disposition of property by petitioner. The gain herein grew out of petitioner's reacquisition of its own obligations, and does not fall into either of the foregoing categories. Accordingly, since section 115(l) does not provide a comprehensive test applicable in all circumstances as the mandatory measure of earnings and profits, and since the present

* Section 115(l) is now § 312(f). Certain other problems in computing "earnings and profits" have been cleared up by the 1954 Code, but we still have no "comprehensive definition." [Ed.]

situation is not covered by the provisions of section 115(l), it becomes necessary to determine petitioner's earnings and profits under the statute apart from these provisions.

That is not to say, however, that section 115(l), and the expression of legislative intent accompanying its enactment, may not be of guidance in the treatment of situations not within its boundaries. When it enacted section 115(l), Congress was aware that an extensive body of interpretative law had grown up in connection with its use of the term "earnings and profits." It was prompted to act, not primarily to change that law, but to make clear in certain areas the extent to which that law was an accurate embodiment of its pre-existing intent. In the words of the Committee on Ways and Means sponsoring the provision which culminated in section 115(l), "The purpose of this amendment is *to clarify* the law with respect to what constitutes earnings and profits of a corporation." (Emphasis added.) H. Rept. No. 2894, 76th Cong., 3d Sess., p. 41. That law, which was then the subject of Congressional examination and which had survived enactment of earlier revenue statutes, treated earnings and profits as unaffected by a transaction on which gain or loss was not recognized for income tax purposes. *Cf. Commissioner* v. *Wheeler,* 324 U.S. 542, 547; *Commissioner* v. *Sansome,* 60 Fed.(2d) 931, 933 (C.A. 2). See also *Commissioner* v. *Munter,* 331 U.S. 210, 214–215. Some decisions had been rendered, however, which increased earnings and profits because of unrecognized gain in connection with corporate reorganizations or related transactions. Congress desired to clarify the law by disapproving the latter decisions (H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41–42) and giving statutory recognition to the principle that "there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss" (Sen. Rept. No. 2114, 76th Cong., 3d Sess., p. 25). It therefore provided in section 115(l) that, as to the sale or other disposition of property,

> Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.

We think that although section 115(l) is not applicable here, it nevertheless gave expression to a concept of "earnings and profits" that was already widely recognized and which inheres in the meaning of those words. *Cf. Commissioner* v. *Estate of Holmes,* 326 U.S. 480, 487–488. Surely, by taking pains to make certain that unrecognized gains or losses from sales or other dispositions of property would not be reflected in earnings and profits, Congress could not have intended thereby to produce a different result with respect to other unrecognized gains or losses, merely by failing to mention them. There is nothing in the history of the Second Revenue Act of 1940, which added section 115(l) to the Code, that suggests any such purpose. Basic considerations with respect to the interpretation of the revenue laws do not allow a taxpayer, in the absence of clear language to the contrary, to elect to postpone the recognition of income for purposes of being taxed, and at the same time permit it inconsistently to treat such unrecognized income as earnings and profits. *Cf. Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, *May, Stern & Co.* v. *Commissioner,* 181 Fed.(2d) 407 (C.A. 3), certiorari denied, 340 U.S. 814; *White Bros. Co.* v. *Commissioner,* 180

Fed.(2d) 451 (C.A. 5), certiorari denied, 340 U.S. 825; *Benjamin Siegel*, 29 B.T.A. 1289; *Corinne S. Koshland*, 33 B.T.A. 634.

Nor is the result sought by petitioner required by the fact that Congress in 1942 amended section 115(l) by adding the sentence dealing with wash sales.* For, notwithstanding the concern which prompted the enactment of the 1942 amendment, it is quite possible that the provisions as they stood prior to the 1942 amendment might have produced the same result, just as the original enactment in 1940 of section 115(l) itself was regarded in certain respects merely as declaratory of existing law in *Commissioner* v. *Wheeler*, 324 U.S. 542. Moreover, the report of the House Ways and Means Committee which sponsored the amendment, in making known its impression that disallowed losses from wash sales could affect earnings and profits under section 115(l) as it then stood, made clear its understanding that giving such effect to those losses would be "contrary to the uniform practice prior to the enactment of Section 501 of the Second Revenue Act of 1940." H. Rept. No. 2333, 77th Cong., 2d Sess., p. 93. The purpose of the amendment was to assure adherence to that uniform practice, which was thought to have been interrupted by section 115(l). As we have observed, there may well be some doubt that section 115(l), as it was originally enacted in 1940, caused such an interruption. But whatever view is taken in this regard, a wash sale, unlike income from discharge of indebtedness, is a transaction with respect to property within the general coverage of section 115(l), and any change in practice produced by that section affected the treatment of the former only. The rule we deem applicable to this case is that of the "uniform practice" understood by the legislature to have obtained prior to 1940 respecting wash sales, and that practice supports the conclusion that unrecognized income from discharge of indebtedness is to be excluded from earnings and profits.

The present case must be distinguished from situations where fully realized income which is exempt from tax, such as interest on state bonds, is included in earnings and profits. See Treasury Regulations 118, Sec. 39.115(a)-2. Although the general introductory language of section 22(b) of the Code characterizes the various types of income in the subdivisions to follow as "exempt," the fact is that, under the specific provisions of section 22(b)(9), the income from discharge of indebtedness escapes taxation only by reason of the option in section 22(b)(9), and the effect of exercise of the option is not a complete withdrawal or insulation of the profit from tax. Unlike other exclusions from income provided for by section 22(b), the profit from discharge of indebtedness is excluded only on the condition that it be applied in reduction of the basis of property held by the petitioner. Sections 22(b)(9), 113(b)(3), Internal Revenue Code. In reality, by providing for an adjustment altering the basis of property which petitioner would otherwise be entitled to use, Congress did not relieve the profit of tax but only postponed the time for levying the tax. Instead of collecting a tax on the profit when received, Congress merely deferred recognition of the profit and collection of the tax until the time at which the property with the reduced basis was sold or otherwise disposed of.[1] See *Commissioner* v. *Jacobson*, 336 U.S. 28, 44–46.

* § 312(f)(1), last sentence [Ed.]

[1] Where the property involved is of a depreciable character, recognition may occur gradually over the years by reason of the smaller depreciation deductions which result from the reduction in the basis of the property. Thus, in this very case there was a reduction in depreciation and related items in 1942 to the extent of $1,736.69, which petitioner does not contest, and which is reflected in its accumulated earnings and profits.

This method of treating the profit is comparable to the treatment accorded nontaxable exchanges governed by the so-called reorganization provisions in section 112 of the Code [§ 354, 1954 Code], where recognition is similarly postponed. In both situations, the earnings and profits are affected, not at the time of the original unrecognized transaction, but at the time that the gains or losses are actually taken into account in computing taxable income. True, the result with respect to section 112 transactions, dealing with sales and exchanges, is specifically called for by section 115(l),[2] but, as we have seen, section 115(l) was merely declaratory of existing law in this regard, and the same result is required by a proper interpretation of the term "earnings and profits."

Moreover, petitioner's position is open to the objection that it might actually require the same gains to be included twice in its earnings and profits. As the Supreme Court emphasized in *Commissioner* v. *Wheeler,* 324 U.S. 542, 547, section 115(l) expressly prescribes, as the basis for computing gain or loss for purposes of earning and profits, "the adjusted basis . . . for determining gain." As to the property affected by petitioner's election in the instant case, the adjusted basis for determining gain is the basis as adjusted downward under section 113(b) (3) [§ 1017, 1954 Code]. When petitioner disposes of that property, the adjusted basis will increase the taxable gain or decrease the deductible loss. Since use of the same basis seems to be required under section 115(l), a comparable increase in earnings and profits apparently will take place at the time of disposition of the property. If this consequence follows from the adjustment in basis under section 113(b)(3), there would be a duplication in the increase in petitioner's earnings and profits were they also to be increased, as petitioner contends they should be, upon the realization of the bond profit responsible for the basis adjustment. A construction which involves such an irrational result is to be avoided in the presence of an acceptable alternative. *Cf. Taylor-Wharton Iron & Steel Company,* 5 T.C. 768, 781–783.

Reviewed by the Court.

Decision will be entered for the respondent.

Note

1. The Tax Court was affirmed, with an opinion that accepts the Tax Court's reasoning, in *Bangor & Aroostook R. Co.* v. *Commissioner,* 193 F 2d 827 (1st Cir. 1951), cert. den. 343 U.S. 934.

2. Many more adjustments are required to convert taxable income into earnings and profits; for details, the articles of Rudick and Albrecht, *supra*, p. 484, should be consulted. Certain previously unsettled problems are expressly dealt with in the 1954 Code, and will be referred to hereafter.

[2] Indeed, petitioner suggests that section 115(l) was intended to deal exclusively in this connection with section 112 transactions, and that the only unrecognized gain which does not augment earnings and profits is the gain which is relieved of tax by section 112. While it is true that the committtee reports accompanying the legislation which added section 115 (l) to the Code made prominent reference to section 112, both the Senate Finance Committee and the Conference Committee indicated that section 112 was mentioned only by the way of illustration in referring to realized but unrecognized gains that do not increase earnings and profits; the reports of these committees explicitly used such phrases as "for instance" and "for example" in referring to section 112. See Sen Rept. No. 2114, 76th Cong., 3d sess, pp. 23-24, H. Rept. No. 3002, 76th Cong., 3d sess., p. 60. Thus, even if section 115 (l) governed the present situation, the effect which petitioner seeks to attribute to it is not justified by its legislative history.

2. *Disguised Dividends*

Just as the Code does not define "earnings and profits," so also it fails to define "distribution." We have already encountered two examples of disguised corporate distributions that will be taxed as "dividends" if the corporation has post-1913 earnings and profits

(1) Purported "salary" that is not compensation for services but rather a distribution to a stockholder-employee or to a donee of a stockholder. *Supra*, p. 239. A dividend may also be disguised as rent, royalties, or as the purchase price for property transferred to the corporation by the stockholders. If such payments are excessive, the excess will be taxed as a dividend. *Cf. Staab* v. *Commissioner*, 20 T.C. 834 (1953); *Crabtree* v. *Commissioner*, 22 T.C. No. 9 (1954).

(2) "Interest" on hybrid securities or on evidences of indebtedness issued by an under-capitalized corporation that are the equivalent of stock. *Supra*, pp. 481–2.

To these should be added·

(3) Sales of corporate property to stockholders for less than fair market value, and rent-free use of corporate property. Regs. 118, Sec. 39.22(a)-1(b), *Byers* v. *Commissioner*, 199 F.2d 273 (8th Cir. 1952), *cf. Dean* v. *Commissioner*, 9 T.C. 256 (1947).

(4) "Loans" by a corporation to its stockholders that are not intended to be repaid. See *Regensburg* v. *Commissioner*, 144 F.2d 41 (2d Cir. 1944).

See generally Toll, "Constructive Dividends," 1951 *So. Calif. Tax Inst.* 211.

Section F. Distributions of Earnings by the Liquidating Corporation

1. *Complete Liquidations*

> *Note:* **Section 331 of the 1954 Code, relating to complete liquidations, is substantially the same as § 115(c) of the 1939 Code.**
>
> **Section 332 of the 1954 Code, relating to complete liquidations of subsidiary corporations, is substantially the same as § 112(b)(6) of the 1939 Code.**
>
> **Section 333 of the 1954 Code, permitting an election as to recognition of gain in certain complete liquidations, is substantially the same as § 112(b)(7) of the 1939 Code.**
>
> **See Regs. 118, Secs. 39.115(c)-1, 112(b)(7)-1-5, and 112(b)(6)-1-5.**

Section 331(a) provides that on a complete liquidation of a corporation the stock shall be treated as though it had been sold, so that the stockholder realizes gain or loss on the difference between the adjusted basis of the stock he surrenders and the value of what he receives. Thus the earnings and profits account, so critical to the tax status of the distributions of a going concern, becomes irrelevant when the distribution is in complete liquidation. In analogizing a complete liquidation to a sale rather than to a dividend, § 331(a) carries forward a policy established in 1924, though for a period (1934–36) liquidations were short-term capital transactions whereas a sale could give rise to either short or long-term gain or loss. Is the analogy to a sale valid?

The fact that the corporate earnings and profits account is obliterated by a complete liquidation is of central importance to the progressive rate structure of the federal income tax. We have already noted that the earnings of a corporation, unlike those of a partnership or individual proprietorship do not run the gauntlet of the individual tax rates when earned. Now we find that on a complete liquidation, the earnings may be received by the stockholder as capital gain. To be sure, they could be converted into capital gain by an alternate route sale of the stock. But unless the buyer was assured of a painless way of extracting the earnings, he might follow the *Phellis* suggestion (*supra*, p. 484) of discounting his price by the prospect of the tax. Thus § 331 makes it possible to receive corporate earnings at the capital gains rate, either by selling the stock or by liquidating the corporation.

BITTKER AND REDLICH
CORPORATE LIQUIDATIONS AND THE INCOME TAX

5 Tax L. Rev. 437-438 (1950)
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"In addition to the tax loopholes I have described, there are a number of others which also represent inequities, and should be closed Most of these permit individuals, by one device or another, to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual income-tax rates, would be taxed only at the capital gains rate Thus, they might escape as much as two-thirds of the tax they should pay." [1]

President Truman has called the attention of Congress to the "collapsible corporation," one more of the perennially alluring contrivances for transmuting ordinary income into capital gain. A motion picture producer and the leading performers organize a corporation to manufacture and market a single film They invest nominal amounts, receiving the corporation's stock in return, and the corporation borrows enough to defray the costs of production. Since the producer and the key performers receive modest salaries, if any, the costs of production are appreciably less than normal. After the picture has been completed, contracts for its distribution are made by the corporation Then the corporation is liquidated, the shareholders surrendering their stock in exchange for proportionate interests in the distribution contracts. Since section 115(c) of the Internal Revenue Code [now § 331] provides that a complete liquidation shall be treated like a sale, the shareholders report a capital gain of the difference between the value of the contracts (which can be estimated from the film's early reception) and the cost basis of the shares. The gain is long-term if the shares have been held for more than six months. The value reported for the shareholder's rights under the contract is then depreciated over the estimated commercial life of the film. If the net receipts correspond to the reported value, there will be no further gain or loss.

[1] President Truman's tax message to Congress, N. Y. Herald Tribune, Jan. 24, 1950, p. 14.

If, however, the receipts depart from the estimate, the shareholder will realize ordinary income or loss in the amount of the difference.[2] It is immediately patent that the value of the contracts, received on liquidation, or their proceeds are intended by all concerned to be remuneration for the shareholders' previously uncompensated personal services. The Treasury Department reported to the Congress that in one such case an independent producer and his wife realized a net gain of $615,000, taxed only at 25 per cent rather than at the enervatingly higher rate which would have been applicable if the gain had been received as salary for his services.

The President took film production as his example in illustrating this tax "loophole," though it . . . is suited to any industry characterized by short-term enterprises, such as real estate, construction, novelties, and others. The Treasury Department alone knows the extent of its use, but it is unlikely that only the motion picture industry has succumbed to the lure of "25 per cent money." [3]

Note

1. To curb use of the "collapsible corporation," Congress enacted in 1950 what is now, with some modifications, § 341. When applicable, § 341 requires the gain on either the liquidation of a collapsible corporation or the sale of its stock to be reported as ordinary income instead of as capital gain. The crux of § 341 is its requirement that the corporation be "formed or availed of principally . . . with a view" to a sale (including a liquidation) of its stock or a distribution of its property prior to its realization "of a substantial part of the taxable income to be derived" from its property. When originally enacted, the provision embraced only corporations that "manufactured, constructed, or produced" property; Congress had in mind primarily the motion picture and building construction industries. In 1951, the section was expanded to include corporations purchasing inventory property and stock in trade. The purpose of the amendment was to prevent the appreciation on inventory property or stock in trade from being realized as a capital gain by a transfer of such property to a corporation under § 351 followed by a sale of the stock of the corporation. In *Jacobs* v. *Commissioner*, 21 T.C. 165 (1953), a corporation organized under such circumstances was disregarded even without the help of § 341, and the sale was treated as a sale of the property by the original owner (producing ordinary income) rather than as a sale by him of the stock of the corporation.

See the presumption of § 341(c), added in 1954.

See generally DeWind, "Collapsible Corporations Under the Revenue Act of 1950," 1951 *So. Calif. Tax Inst.* 583; Note, Legislative Response to the Collapsible Corporation, 51 *Col. L. Rev.* 361 (1951); and, for a discussion of the regulations under § 117(m), MacLean, "Collapsible Corporations—The Statute and Regulations," 67 *Harv. L. Rev.* 55 (1953).

2. Was § 341 necessary? When it was enacted, the Congressional committees stated that "no inference shall be drawn from the amendment with respect to gains realized prior to 1950." H. Rept. No. 2319 and S. Rept. No. 2375, 81st Cong. 2d Sess., 50-2 C.B. 380, 451, 516. Could the collapsible corporation be assailed successfully with such weapons as *Commissioner* v. *Laughton, supra,* p. 352; *Lucas* v. *Earl, supra,* p. 298; and *Higgins* v. *Smith,* 308 U.S. 473 (1940)? See Bittker and Redlich, "Corporate Liquidations and the Income Tax," 5 *Tax L. Rev.* 437, 437-448 (1950).

[2] On the possibility of reporting as capital gain rather than as ordinary income any subsequent receipts which exceed the value of the contracts at the time of liquidation, see Brodsky and King, "Tax Savings Through Distributions in Liquidation of Corporate Contracts," 27 Taxes 806 (1949).

[3] The Treasury [reported to Congress] that "there are over a hundred cases being examined by the Bureau of Internal Revenue," and that the device "is also being used to some extent in the building and construction trades."

In the only reported case of an attempt by the Treasury to disregard the liquidation of a collapsed corporation, it lost. *Herbert* v. *Riddell,* 103 F. Supp. 369 (S.D. Calif. 1952). There, however, the court found that the stockholders did not intend to collapse the corporation when they organized it; the liquidation was decided upon subsequently, as a result of a difference of opinion among its stockholders as to future business policy.

3. Whether the liquidation produces ordinary income under § 341 or capital gain under § 331, the distributed property will take on a stepped-up basis. If subsequent receipts in respect of such property exceed its basis, will the taxpayer realize ordinary income or capital gain?

4. Section 331 provides that amounts distributed in complete liquidation shall be treated as though they had been received on a sale or exchange of the stock. Ordinarily, the gain or loss thus computed, which will be capital gain or loss if (as is ordinarily the case) the stock is a capital asset, is fully recognized under the general rule of § 1002. Two important exceptions should be noted here.

Section 333. This provision was enacted in 1943, but it was then applicable only to certain corporate liquidations occurring in 1944. It was revived by the Revenue Act of 1950 for liquidations taking place in 1951, and was later amended, so as to embrace 1952 and 1953 liquidations It became a permanent part of the Code in 1954.

Section 333's principal function is to permit a corporation holding appreciated assets but having no earnings and profits or cash (e g., a real estate holding corporation) to be liquidated without the recognition of any gain. The stockholders, however, hold the distributed assets with a basis equal to the basis of the surrendered stock. Section 334(c). If the liquidated corporation had either earnings and profits or cash, gain is recognized *pro tanto* Stock or securities acquired by the corporation after December 31, 1953 (the date § 333 was revived) are treated as the equivalent of cash. Use of § 333 is optional with the stockholders. Moreover, it provides for the non-recognition of gain only. If the liquidation produces loss rather than gain, the loss would be recognized under § 331. See Eaton, "Liquidation Under Section 112(b) (7)," 38 *Va. L. Rev.* 1 (1952); *Osenbach* v. *Commissioner,* 198 F.2d 235 (4th Cir. 1952); *Meyer's Estate* v. *Commissioner,* 200 F.2d 592 (5th Cir. 1952).

Section 332. This provision provides in substance that no gain or loss shall be recognized on the liquidation of a subsidiary corporation The provision, which was enacted in an earlier form in 1935, was proposed by the Treasury as a measure to encourage the simplification of elaborate corporate structures. In the absence of such a non-recognition provision, unnecessary subsidiary corporations could be eliminated (if they were successful enterprises) only by paying a capital gains tax under the general rule, § 331, applicable to complete liquidations. Unlike § 333, § 332 is not optional; moreover, it provides for the non-recognition of both gain and loss.

Section 332's basis provision, § 334(b) (1), does not follow the usual practice of giving the property received on a tax-free exchange the same basis as the property given up, as does § 358, for example. Instead, § 334(b) (1) provides that, as a general rule, the transferee (the parent corporation) takes over the basis of the transferor—its subsidiary. This will be advantageous if the subsidiary has a high basis for its assets, but disadvantageous when its basis is low. The disadvantage is especially striking if the parent acquired the subsidiary by purchasing its stock for the fair market value of the assets and if the subsidiary's basis for those assets is low

KIMBELL-DIAMOND MILLING CO. v. COMMISSIONER

Tax Court of the U.S., 1950

14 T.C. 74 aff'd. 187 F.2d 718 (5th Cir.), cert. den. 342 U.S. 827 (1951)

[After a fire destroyed the taxpayer's plant, it purchased for $210,000 in cash all of the stock of Whaley Mill & Elevator Co., in order to use Whaley's plant and

equipment to replace its own. The purchase price was made up of $120,000 of insurance proceeds and $90,000 of additional funds.* Taxpayer liquidated Whaley three days after acquiring the stock. In a previous proceeding, reported at 10 T.C. 7 (1948), the Tax Court held that the acquisition of Whaley by the taxpayer came within § 112(f), so that its gain on the involuntary conversion (amounting to $100,000, the difference between the insurance proceeds of $120,000 and the adjusted basis of the destroyed assets, $20,000) was not recognized. Since the taxpayer's acquisition of the Whaley stock qualified under § 1033, its basis for the stock would not be the full price ($210,000), but only $110,000 (*i.e.*, the adjusted basis of the plant that was destroyed by fire, $20,000, plus the $90,000 of funds which were paid in addition to the insurance proceeds).

[The assets of Whaley, which were acquired by the taxpayer upon liquidating Whaley, had an adjusted basis in Whaley's hands of more than $300.000; the depreciable assets represented about $140,000 of this amount.]

Black, Judge: . . .

Petitioner argues that the acquisition of Whaley's assets [stock?] and the subsequent liquidation of Whaley brings petitioner within the provisions of section 112(b)(6) [§ 332, 1954 Code] and, therefore, by reason of section 113(a)(15) [prescribing what is the "general rule" of § 334(b)(1), 1954 Code], petitioner's basis in these assets is the same as the basis in Whaley's hands. In so contending, petitioner asks that we treat the acquisition of Whaley's stock and the subsequent liquidation of Whaley as separate transactions. It is well settled that the incidence of taxation depends upon the substance of a transaction. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. . . . It is inescapable from petitioner's minutes . . . and from the "Agreement and Program of Complete Liquidation" entered into between petitioner and Whaley, that the only intention petitioner ever had was to acquire Whaley's assets.

We think that this proceeding is governed by the principles of *Commissioner* v. *Ashland Oil & Refining Co.*, 99 Fed.(2d) 588, certiorari denied, 306 U.S. 661. In that case the stock was retained for almost a year before liquidation. Ruling on the question of whether the stock or the assets of the corporation were purchased, the court stated:

> The question remains, however, whether if the entire transaction, whatever its form, was essentially in intent, purpose and result, a purchase by Swiss of property, its several steps may be treated separately and each be given an effect for tax purposes as though each constituted a distinct transaction. . . . And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority. *Prairie Oil & Gas Co.* v. *Motter*, 10 Cir., 66 F.2d 309; *Tulsa Tribune Co.* v. *Commissioner*, 10 Cir., 58 F.2d 937, 940; *Ahles Realty Corp.* v. *Commissioner*, 2 Cir, 71 F 2d 150; *Helvering* v. *Security Savings Bank*, 4 Cir., 72 F.2d 874.

See also *Koppers Coal Co.*, 6 T.C. 1209 and cases there cited.

We hold that the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of Whaley's assets which was petitioner's sole intention. This was not a reorganization within

* All figures have been rounded off, in the possibly vain hope of simplifying the issues. [Ed.]

§ 112(b)(6), and petitioner's basis in these assets, both depreciable and nondepreciable, is, therefore, its cost,† or $110,000 ($20,000 the basis of petitioner's assets destroyed by fire, plus $90,000, the amount expended over the insurance proceeds). Since petitioner does not controvert respondent's allocation of cost to the individual assets acquired from Whaley, both depreciable and nondepreciable, respondent's allocation is sustained.

Note

1. Note the "exception" to the general basis rule, set out in § 334(b) (2). This provision is new in the 1954 Code, and it is based on the *Kimbell-Diamond* case.

2. In *Snively* v. *Commissioner*, 19 T.C. 850 (1953), the Tax Court, relying on the *Ashland Oil* case, held that an individual did not realize gain under what is now § 331 when he liquidated a corporation whose stock he had acquired six months earlier for the primary purpose of obtaining the corporate assets. See *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090 (1952), and *cf. Distributors Finance Corp.* v. *Commissioner*, 20 T.C. 768 (1953). The court also held that the income produced in the interim by the corporate assets should be taxed to the corporation, rather than to the stockholder, despite the plan to liquidate:

> The stock purchase coupled with the intent to dissolve the corporation and the taking of some steps to that end, in our opinion did not *ipso facto* either destroy the existence of the corporation as a taxable entity or permit the petitioner to appropriate as his own income which would otherwise be taxable to the corporation. (19 T.C. 850, 858.)

3. Until 1954, there were no statutory rules to prescribe the effect of a liquidation of a subsidiary corporation on the earnings and profits of the parent. It was held that the subsidiary's earnings and profits were passed up to the parent in *Robinette* v. *Commissioner*, 148 F.2d 513 (9th Cir. 1945); but in *Commissioner* v. *Phipps*, 336 U.S. 410 (1949), it was held that the subsidiary's deficit in earnings and profits did not reduce the parent's earnings and profits account. See Rice, "Transfers of Earnings and Deficits in Tax-Free Reorganizations The Sansome-Phipps Rule," 5 *Tax L. Rev.* 523 (1950).

Section 381 of the 1954 Code now provides statutory guidance for these and related problems.

4. If a corporation wishes to avoid § 332 in order to recognize loss on the liquidation of a subsidiary, can it accomplish its aim by selling some of the stock so that it owns less than 80%? Before 1954, § 112(b) (6) (the predecessor of § 332) provided that a disposition of any stock by the parent between the time the plan of liquidation was adopted and the time it was consummated would take the transaction out of the tax-free category. This restriction was removed by the 1954 Code "with the view to limiting the elective features of the section." S. Rept. p. 255. Does this mean, by negative inference, that a sale to reduce ownership below 80% will be effective? See Colgan and Molloy, "Tax-Free Liquidations of Corporate Subsidiaries under Section 112(b) (6) of the Internal Revenue Code," 4 *Tax L. Rev.* 305, 333–334 (1949); Busterud, "The Liquidation of Subsidiaries under Section 112(b) (6)," 58 *Yale L.J.* 1050 (1949).

2. *Partial Liquidations*

Note: **Section 331(a)(2) of the 1954 Code, relating to partial liquidations, states the same rule as § 115(c) of the 1939 Code.**

Section 346 of the 1954 Code, defining partial liquidation, is substantially expanded from § 115(i) of the 1939 Code.

† The court is using the term "cost" in a rather special way The cash outlay was $210,000, but because gain on the fire in the amount of $100,000 went unrecognized by virtue of § 1033, the taxpayer's basis is only $110,000. [Ed.]

Section 302 of the 1954 Code, relating to the redemption of stock, is derived from § 115(g) of the 1939 Code, but with substantial modifications.

Section 317 of the 1954 Code, defining redemption, is new.

The cases that follow, decided under § 115(g) of the 1939 Code, present the problems that the 1954 changes were intended to solve.

COMMISSIONER v. ROBERTS

U.S. Court of Appeals, Fourth Circuit, 1953
203 F.2d 304

Before PARKER, Chief Judge, and SOPER and DOBIE, Circuit Judges.

DOBIE, Circuit Judge.

This is a petition by the Commissioner of Internal Revenue to review a decision of the Tax Court of the United States. The Tax Court held that the distribution in connection with the redemption of the stock of the corporation, *under the circumstances of this case*, was not essentially equivalent to, and not taxable as, the distribution of a dividend under section 115(g) of the Internal Revenue Code.* We think the decision of the Tax Court was clearly erroneous. It must, therefore, be reversed. . . .

There is little or no dispute about the facts of this case. In March, 1932, John T. Roberts, hereinafter called taxpayer, and his brother transferred to a newly created corporation all of the assets of a wholesale plumbing and heating supply business, theretofore conducted by them in partnership, in exchange for all of the stock of the corporation, consisting of 2,000 shares of common stock, par value $100 each. Fifteen hundred shares were issued to taxpayer, who continued to hold them through the taxable year 1944 here involved. Five hundred shares were issued to taxpayer's brother. Taxpayer's brother died in October, 1943, and by his last will made a specific bequest to taxpayer of any shares of stock of the corporation owned by him at the time of his death. Pursuant to an order of the probate court, the executor of the brother's will transferred to taxpayer stock certificates for the 500 shares of the corporation's stock which the brother had owned. These 500 shares were valued for estate tax purposes at $92,000.

During the war the business of the corporation was adversely affected by Government regulations, and during the period 1941 to 1944 the difficulties of operating increased. Gross sales in 1939 were roughly $771,000; increased to $1,677,000 in 1941; and dropped in succeeding years to a low of $400,000 in 1944. Adjusted net income (that is, prior to taxes) amounted to roughly $28,000 in 1939; $47,000 in 1940, $63,000 in 1941, $106,000 in 1942; $49,000 in 1943, and $13,000 in 1944.

* Section 115(g) provided "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend"

On the other hand, Section 115(c) provided that a partial liquidation should be treated, by the stockholder, like a sale, so that he would realize capital gain or loss if, as is ordinarily the case, the stock is a capital asset [Ed]

On January 1, 1944, total assets amounted to approximately $414,000 (including cash of $160,000 and United States obligations of $96,000), and the earned surplus amounted to approximately $170,000. As of December 31, 1944 (that is, after the distribution in redemption of stock here involved), the corporation's balance sheets showed assets of $320,000 (including cash of $60,000 and United States obligations of $106,000) and an earned surplus of $135,000.

The corporation paid a dividend of $4 a share in 1934; $16 in 1935; $8 in each year 1936 through 1940; $6 in 1941; and no dividends in 1942 and 1943. In 1944, after the stock redemption hereinafter mentioned, a dividend of $2 was distributed. In 1944 taxpayer also was paid a salary of $27,900 by the corporation as its president.

On December 26, 1944, at a special meeting of the corporation's board of directors, on motion of taxpayer, it was resolved that the corporation purchase from taxpayer for $92,000 the 500 shares of stock which taxpayer had acquired by bequest from his brother, and that the capital stock of the corporation be reduced to 1,500 shares, par value $100. On the same day, a special meeting of the stockholders (namely, taxpayer, for he then owned all the shares of stock in this corporation) approved, the transaction was completed; and an amendment to the certificate of incorporation was executed which was later approved by the State Tax Commission. Taxpayer never considered selling his shares to anyone but the corporation because he wanted to keep the stock in the family.

The taxpayer did not report the transaction in controversy on his return, and the Commissioner determined a deficiency on the ground that the amount of $92,000 paid by the corporation was taxable as a dividend.

The Tax Court specifically found that the earnings and profits of the corporation prior to and during 1944 were accumulated for no definite purpose, that the operations of the corporation were not impaired by reason of the transaction in controversy, and that the corporation had never followed a policy of contraction of business; that the corporation's financial position on December 26, 1944, permitted of a dividend of $92,000, and that the corporation continued in the same business in subsequent years.

The Tax Court further found that the payment of the $92,000 to taxpayer by the corporation in the taxable year was a distribution in complete cancellation and redemption of all of that portion of the corporation's stock bequeathed by taxpayer's brother, constituting a partial liquidation, and not the essential equivalent of the distribution of a taxable dividend.

We cannot agree with the holding of the Tax Court that, as of the time of the stock redemption, the stock acquired by taxpayer which was redeemed, must be regarded as the stock of the brother. This runs absolutely counter to reality. This stock had been the brother's, but, months before the redemption, taxpayer's title to this stock had been completely perfected. See, *Matthews* v. *Turner and Woodyard*, 64 Md. 109, 121, 21 A. 224.

The vital thing here, as we see it, is that, by the redemption of this stock, the *essential relation* of the taxpayer to the corporation was not, in any practical aspect, changed. Before the redemption, he was the sole stockholder in the corporation; after the redemption, he was still the sole stockholder. Of what real consequence was it that before the redemption his sole ownership was divided into

2,000 shares, and after the redemption, this same sole ownership was divided into 1,500 shares: He owned the whole corporation before the redemption; after the redemption, he was still the sole owner.

Here, then, we find a single individual owning all the corporate stock. *Flanagan* v. *Helvering*, 73 App. D.C. 46, 116 F 2d 937, *Bazley* v. *Commissioner*, 3 Cir. 155 F.2d 237, 239, affirmed 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782. The corporation had on hand a large and unnecessary accumulation of cash, representing "earnings or profits accumulated after February 28, 1913." *Hirsch* v. *Commissioner*, 9 Cir., 124 F.2d 24, 29. The corporation did not then intend to liquidate or to contract its business. *Rheinstrom* v. *Conner*, 6 Cir. 125 F.2d 790, 793, certiorari denied 317 U.S. 654, 63 S. Ct. 49, 87 L. Ed. 526. The redemption served no business purpose of the corporation; it was motivated entirely by the personal considerations of taxpayer. *Commissioner* v. *Snite*, 7 Cir., 177 F.2d 819, *Smith* v. *United States*, 3 Cir., 121 F.2d 692, 695. The net effect of the redemption was clearly to distribute to taxpayer the corporate earnings just as if a cash dividend had been declared. *Kirschenbaum* v. *Commissioner*, 2 Cir., 155 F.2d 23, 170 A.L.R. 1389, certiorari denied 329 U.S. 726, 67 S. Ct. 75, 91 L. Ed. 628; *Hyman* v. *Helvering*, 63 App. D.C. 221, 71 F.2d 342, certiorari denied 293 U.S. 570, 55 S. Ct. 100, 79 L. Ed. 669. See, also, Nolan, "The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal," 65 *Harv. L. Rev.* 255; Pedrick, "Some Latter Day Developments in the Taxation of Liquidating Distributions," 50 *Mich. L.R.* 529. Indeed, it is difficult to imagine a more ideal set-up for the application of Section 115(g) than the facts involved in the instant case.

The cases of *Flinn* v. *Commissioner*, 37 B.T.A. 1085 and *Tiffany* v. *Commissioner*, 16 T.C. 1443, cited by the Tax Court are clearly not in point There, the corporations purchased all of the stock of a particular stockholder, when there were still other stockholders, here, the corporation merely purchased part of the stock of its sole stockholder. There, the relationship of the stockholder to the corporation was radically changed by the redemption, from stockholder to mere ex-stockholder; here, as we have pointed out, there was no such change for, both before and after the redemption taxpayer was and remained the sole stockholder of the corporation.

The ultimate question of whether, in a particular case, section 115(g) does or does not apply, is usually held to be a question of fact. *Boyle* v. *Commissioner*, 3 Cir., 187 F.2d 557, certiorari denied 342 U.S. 817, 72 S. Ct. 31, 96 L. Ed. 618; *Commissioner* v. *Cordingley*, 1 Cir., 78 F.2d 118, *Hill* v. *Commissioner*, 4 Cir., 66 F.2d 45.

The Regulations, which have been in effect for many years, provide in part that a redemption by a corporation of a portion of its stock *pro rata* among all the shareholders would generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. The provision of the Regulations is fully met in the case, and likewise other factors which have sometimes been held relevant are also present here.

It might be noted that while dividends were paid by the corporation here prior to 1942, no dividends were paid by the corporation in 1942, 1943, or 1944 prior to redemption, though the corporate earnings in all these years were quite substantial.

Any conclusion other than that which we have reached readily shows how easily the tactics of the taxpayer here could be used as a means of tax evasion. A prosperous corporation, for example, with a single stockholder, earns large sums of money, available for, and which should be paid out as, dividends. This sole stockholder siphons off this money (as was done in the instant case) to himself by selling a portion of his stock to the corporation at a price per share which will just cover these earnings. Surely, this is a redemption "essentially equivalent to the distribution of a taxable dividend." Congress must have had just such a situation in mind when it enacted section 115(g). See cases previously cited and compare, decided by our Court, *Wall* v. *United States*, 4 Cir., 164 F.2d 462.

The decision of the Tax Court of the United States is reversed and the case is remanded with directions to enter a decision in favor of the Commissioner.

Reversed and remanded with directions.

IMLER v. COMMISSIONER

Tax Court of the U.S., 1948
11 T.C. 836

The Commissioner determined a deficiency of $2,410.27 in the petitioner's income and victory tax for the year 1943. The sole question is, Was the retirement of certain shares of its stock by the Imler Supply Co. in 1942 accomplished at such time and in such manner as to make the distribution and cancellation and redemption essentially equivalent to a taxable dividend? The question arises on the following facts: . . .

Previous to December 1, 1941, the company was engaged in the business of retinning and soldering metals and in the rental of excess space in buildings owned by the company. The company owned 5 buildings, consisting of a 7-story brick building and 4 smaller buildings. The main building was equipped with a large freight elevator capable of carrying automobiles. The company rented space in its buildings to the Allegheny County Milk Exchange at a fixed rental of $650 per month, the exchange being entitled to whatever space it required for its operations. Prior to December 1, 1941, the exchange used all of the sixth floor of the main building and one-half of the seventh floor. The portion of the seventh floor that was not used in the actual operation by the exchange was rented for storing various items of freight, including automobiles.

On December 1, 1941, a fire destroyed the two upper floors of the main building. This building was covered by insurance and in April 1942, the company recovered $28,603 as insurance proceeds on account of the fire.

After the insurance proceeds were received, the company obtained an estimate as to the cost of rebuilding the 2 top floors of the main building, which had been destroyed by the fire. It was estimated that the cost would run from $40,000 to $50,000. The company did not have sufficient cash to rebuild at this cost at that time. Because of war conditions and consequent scarcity of materials, building was difficult. The company decided to remove the 2 top floors of the main building which had been burned out and to place a roof over the fifth floor. It was estimated that the cost of this operation would be $15,340. The company thereupon removed the remains of the top floors and placed a roof over the building at the fifth floor, making a 5-story out of what had been a 7-story building.

Petitioner, who was a director of the company, sought out an employee of the Bureau of Internal Revenue at its Pittsburgh office and requested advice as to the treatment to be accorded the leftover fire insurance proceeds. Imler was advised that if the funds were used to retire part of the company stock at par, the transaction would not be taxable as a dividend. . . .

[The corporation thereupon reacquired about one-half of its outstanding shares, approximately proportionately from its shareholders, at par ($50) for a total consideration of $15,000 in cash.]

The cash working capital of the company for some years prior to December 1, 1941, ranged from $7,500 to $9,000. The cash balance of the company, exclusive of the estimated fire proceeds left after reconstruction of the building, was $9,628.76. At that time approximately $4,500 had been expended on the damaged building and it was estimated that the total cost of repairing and reroofing the building would amount to $15,340. This estimated cost proved to be excessive in the amount of $175.81.

Except for the remaining proceeds of fire insurance, the company could not have paid a dividend in the amount of $15,000 on April 6, 1942, without borrowing money.

After the building was repaired and reduced in size, Imler Supply Co. discontinued its retinning and soldering activities and has never resumed the same. This cessation of activity was primarily due to the fact that the corporation lacked space for storage of articles required in its retinning and soldering operations, together with the fact that war conditions and scarcity of materials made such operations unprofitable. . . .

Van Fossan, Judge: The issue here raised presents a question of fact depending on the circumstances of the particular case. *Rheinstrom* v. *Conner*, 125 Fed.(2d) 790, certiorari denied, 317 U.S. 654. No sole or universally applicable test can be laid down. *Flanagan* v. *Helvering*, 116 Fed.(2d) 937. The statutory provision is couched in broad terms—"at such time and in such manner." Though decided cases are not controlling, they are helpful as indicating what elements have been considered important, *viz.*, the presence or absence of a real business purpose, the motives of the corporation at the time of the distribution, the size of the corporate surplus, the past dividend policy, and the presence of any special circumstance relating to the distribution. . . .

The principal building owned by the company had been damaged by fire in 1941. When the company undertook to repair the building it was found that, because of war conditions, the shortage of building materials, and high costs, it was advisable to abandon 2 damaged floors and reduce the 7-story building to one of 5 stories. The consequence was that the company found its facilities inadequate to carry on the retinning and soldering operations formerly engaged in. Moreover, these operations had proven unprofitable in recent experience because of war conditions and shortage of necessary materials. For these reasons the company discontinued the retinning and soldering operations. This reduction in operations likewise reduced the amount of capital necessary for carrying on the business activities of the company. This was a bona fide contraction of business operations and consequent reduction in capital used. The company thus had a real and legitimate purpose for reducing its outstanding capital stock.

The motives of the corporation were all related to the above business purpose and were, therefore, legitimate and properly conceived. If the excess of insurance proceeds be set to one side, the surplus of the company had remained almost constant for 10 years. The company had followed a conservative dividend policy throughout its history and had not paid a dividend since 1934. The original issuance of the stock had occurred many years before and there was no connection between the issuance and the redemption of the same. There was no special circumstance or condition relating to the distribution excepting the fact that the company had in its hands the excess insurance proceeds which formed the basis of the distribution. We are convinced that, except for the fire and the excess insurance proceeds, there would have been no distribution.

Under the facts here present, the redemption of the company's stock was not accomplished at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend.

Reviewed by the Court.

COMMISSIONER v. SULLIVAN

U.S. Court of Appeals, Fifth Circuit, 1954
210 F.2d 607

Before HUTCHESON, Chief Judge, and HOLMES and RIVES, Circuit Judges.

HOLMES, Circuit Judge. . . .

The Texon Royalty Company, a Delaware corporation, made a distribution in kind on April 1, 1943, to its two sole stockholders in cancellation of 2,000 shares, or two fifths, of its capital stock. . . . The question presented here is whether the redemption and cancellation of the stock was at such time and in such manner as to make the distribution essentially equivalent to a taxable dividend so as to be taxable to the recipients to the extent of Texon's accumulated earnings and profits, instead of being treated as payment in exchange for the stock and subject only to a capital gains tax. In other words, was the distribution taxable under Section 115(g) or 115(c) of the Internal Revenue Code?

The Tax Court held that § 115(g) was inapplicable and, therefore, that the taxpayers' entire gain on the distribution was taxable as a long-term capital gain. This holding was based primarily upon findings of fact, in substance as follows: Texon held a great many producing oil leases outside of the Agua Dulce oil field, which was a high pressure field. A suit for damages from a blowout which occurred in prior operations in that field was pending against Texon at the time of the distribution. The leases transferred needed to be developed, and they were transferred because Texon did not want to take the risk of developing them and because it did not have authority under its charter to drill wells. The same reasons prompted the distribution of its drilling equipment. Another reason was that this equipment could be used in the development of the oil properties transferred. The gas payment and the notes were included in the distribution in order to furnish the distributors with additional capital or credit to aid them in the development of the properties transferred, which was undertaken soon after the distribution. The drilling equipment was transferred by the stockholders to a corporation in connection with the development. The avoidance of taxes was not one of the reasons for the distribution.

The petitioner argues that, if the redemption of stock is made pro rata, any business purpose for the redemption thereof will usually be outweighed by the net effect of the transaction. The respondents contend that the Tax Court has weighed the evidence in this case with regard to the net effect of the transaction as well as to the business purposes of the corporation, and has found that the distribution was dictated by the reasonable needs of the corporate business, not merely to benefit the stockholders by giving them a share of the earnings of the corporation.

The Tax Court's opinion expressly refers to its considering the net effect of the transaction; and we cannot say that it used the wrong test, or that there was any specific test for the issue before it. We agree that the pro rata redemption of stock will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits, but to hold that this is always true would nullify the regulation which sanctions it in some cases and says that the question depends upon the particular circumstances of each case. See Treasury Regulations 118, Secs. 39 115-5 and 39.115-9.

The so-called net-effect test is not a weighted formula by which to solve the issue before the court. The net effect of the transaction is not evidence or testimony to be considered; it is an inference to be drawn or a conclusion to be reached. It is not a solvent but a residuum; it is not a process but a product; it is not a means but an end; it is not a solution but a restatement of the statutory provision; it is the gist of the governing law of the case; it is not a balance for weighing the law against the facts, it is the law itself. "Net effect" is a paraphrase for "essentially equivalent." It is just as if the statute read: "If a corporation redeems its stock in whole or in part, so that the net effect of the transaction is the same as the payment of a taxable dividend, the amount so distributed shall be treated as a taxable dividend." The net-effect test is not a test but an attractive abbreviation of the statute, as to which we shall be on safer ground if we stick to the words of the statute: essentially equivalent.

The distribution of the high-pressure leases and the drilling equipment constituted a contraction of Texon's business. When there is a contraction or shrinkage of corporate business, the need of a corporation for funds to carry on its former activities is largely eliminated. Following a contraction of its activities, and with surplus funds on hand, good business and accounting practices dictated a redemption of a portion of the corporation's capital stock. Failure to reduce its capital would have resulted in the payment of unnecessary capital-stock taxes contrary to good business practices. There were other factual considerations that entered into the decisions of the Tax Court.

Strong as is the pro-rata factor in this case, it is not sufficient in itself to require or authorize us to set aside the findings of the Tax Court and invoke the application of § 115(g). To do so would nullify the regulation that authorizes the complete retirement of any part of the stock, whether or not pro rata among the shareholders. In a number of cases, in applying the so-called net-effect test, some of which held the distribution taxable, the courts have called attention to the fact that there was no purpose on the part of the taxpayer to contract its business or narrow the scope of its operations. In *Flanagan* v. *Helvering*, Justice Vinson (later Chief Justice of the United States) said: "The corporation did not manifest any policy of contraction." 73 App. D.C. 46, 116 F.2d 937, 939. . . .

The decisions of the Tax Court are affirmed.

Affirmed.

RIVES, Circuit Judge (*dissenting*).

Congress has consistently and wisely, I think, been as definite and objective as possible in defining what corporate distributions constitute taxable dividends. It has left as small field as is required by necessity for the operation of such uncertainties and variables as the motives, plans, or business purposes of the corporation or its stockholders. The general rule is that *any* distribution of either money or property by a corporation to its stockholders constitutes a taxable dividend to the extent of the corporation's earnings and profits. Internal Revenue Code Sec. 115 (a) and (b). There is an exception when the distribution is in complete or partial liquidation of the corporation. Sec. 115(c). Even then, however, to the extent that it represents a distribution of earnings or profits, it is treated as a taxable dividend if made "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend". Sec. 115(g). . . .

The Regulations make it clear that the fact that the cancellation or redemption of stock is pro rata is the most important single fact tending to show essential equivalence to the distribution of a taxable dividend. A pro rata redemption of stock does not change the stockholders' proportionate interest in and control over the corporation and is usually a mere formality. It seems to me utterly immaterial whether each of the two stockholders owned 1500 shares, as before the distribution, or 2500 shares, as after the distribution. They each owned fifty percent of the stock both before and after the distribution Their interests in and control over the corporation were not affected in any way.

It seems to me that the fact most frequently mentioned and given greatest weight in the decisions is that the cancellation or redemption of stock was pro rata, or substantially so, and that, therefore, the same proportionate ownership of and control over the corporation existed after the distribution as before.

An essential, of course, is that the corporation had a surplus which could have been distributed by the declaration of a true dividend, and the fact of a large surplus is often mentioned in the decisions. This corporation had accumulated earnings and profits in the amount of either $905,217.95 or $359,878.24. Another fact mentioned in the decisions is the corporation's history as to payment of dividends. The stock redeemed in 1943 was originally issued in 1937, and the corporation had never declared any regular dividends. Another fact mentioned is that the amount paid for the redeemed stock was not based upon value, book or otherwise, and that holds true in this case. Other factors discussed in the cases go to the presence or absence of a business contraction or liquidation purpose or of a tax avoidance motive. On the other hand, that a business purpose prompted the distribution has been regarded as immaterial, and it has been recognized that the absence of a motive of tax avoidance is not determinative of the issue.

The last two subjective purposes or motive factors are the only ones tending to support the majority decision. There were business needs and purposes of the corporation as explained in the majority opinion for a distribution of the properties except as to two of those properties, the gas payment and notes receivable having a total fair market value of $774,036.27. Those two were included in the distribution for the stockholders' benefit rather than by reason of any business

purpose of the corporation. As to the distribution of the other properties, the corporation's business purposes and needs furnished no reason for the redemption of stock accompanying the distribution Such distribution, or any disposition, of these properties could have been made just as well without as with the redemption of stock.

The only real reasons suggested for the redemption of stock were to reduce capital stock taxes, usually a very small factor, and to accord with good business and accounting practices. If those reasons were really substantial, they did not call for any liquidation, even partial, of the corporation, but merely for a simple amendment of the corporate charter A mere change in capital structure is not, in and of itself, a legitimate business reason for the redemption of stock. *Bazley* v. *Commissioner*, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782

It seems to me that the law is clearly to the effect that the actual conduct of the parties and the objective results of the distribution and redemption of stock, rather than any business motives, needs or purposes, furnish the controlling factors for the application *vel non* of § 115(g). Whatever may have been the mental ratiocinations of the two stockholders and the assumed business purposes and needs of the corporation, their conduct and the results thereof were "essentially equivalent to the distribution of a taxable dividend." Their acts seem to me more important taxwise than their intentions.

I, therefore, respectfully dissent.

Note

1. In approaching the 1954 amendments in this area, the student should note that under the 1939 Code, the term "partial liquidation" embraced any "distribution by a corporation in complete cancellation or redemption of a part of its stock" Section 115(i). Under § 115(c), a partial liquidation was treated like a sale or exchange of the stock (producing capital gain or loss if the stock was a capital asset), unless the cancellation or redemption was "essentially equivalent to the distribution of a taxable dividend" under § 115(g).

The 1954 Code seeks to divide redemptions of stock into (a) "partial liquidations" under § 331(a) (2) (always treated like a sale or exchange of the stock) and (b) "redemptions" under § 302 (treated either like a sale or exchange of the stock or like an ordinary distribution). The dividing line between the two categories is not entirely clear, though it *is* clear that the two categories overlap to some extent.

Section 346 provides that a distribution "shall be treated as in partial liquidation" under certain circumstances. The most important requirement, to be found in § 346(a) (2), is that the distribution "is not essentially equivalent to a dividend." Section 346(b) gives one example of a distribution that qualifies as a distribution in partial liquidation: a specifically limited type of corporate contraction. But it is explicitly stated in § 346(a) (2) that the kind of corporate contraction set out in § 346(b) is only *one* kind of distribution that qualifies, and we are not told what the characteristics of the others are, except that they cannot be "essentially equivalent to a dividend." The Senate Report says (p. 262) of § 346(a): "Primarily, this definition involves the concept of 'corporate contraction' as developed under existing law. . . . It is intended that a genuine contraction of the business as under present law will result in partial liquidation. See, for example, *Joseph Imler* (11 T.C. 836). However, a distribution of a reserve for expansion is not a partial liquidation." But nothing in the language of § 346(a) appears to require a corporate contraction. It says only that ". . . a distribution shall be treated as in partial liquidation of a corporation if— . . . the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan. . . ."

In addition to §§ 331(a) (2) and 346, the 1954 Code contains § 302, dealing with redemptions. Subsection (a) of § 302 sets out a "general rule" that certain redemptions of stock shall be treated like sales or exchanges, and subsection (d) of § 302 states that all other redemptions shall be treated like ordinary distributions under § 301 (which means that they will be taxed as dividends if the corporation has earnings and profits) The sheep are separated from the goats by § 302(b), which describes three types of redemptions (a fourth is not here important*) that will qualify for the favorable treatment. The first is our old friend, a redemption that "is not essentially equivalent to a dividend." § 302(b) (1). The second is a "substantially disproportionate redemption" (as defined), and the third is a complete redemption of all of the stock owned by the stockholder. §§ 302(b) (2) and (3). But § 302(c) provides that in determining the ownership of stock for § 302, the constructive ownership rules of § 318(a) are applicable Since they provide that an individual is "considered as owning" the stock owned directly or indirectly by or for his spouse, children, grandchildren, and parents, as well as that owned by partnerships, estates, trusts, and certain corporations in which he is interested, it is apparent that in the case of many closely-held corporations it will be impossible for any shareholder to qualify under § 302(b) (2), relating to "substantially disproportionate" redemptions. It would also often be impossible in such circumstances to qualify under § 302(b)(3) (redemption of all stock owned by the stockholder) except that § 302(c)(2) moderates the constructive ownership rules in certain circumstances.

What is the relation between paragraphs (2) and (3) of § 302(b) and paragraph (1) thereof? If a redemption would qualify under (2) (substantially disproportionate redemption) or under (3) (redemption of all stock owned by the stockholder) were it not for the constructive ownership rules of § 318(a), could the redemption be brought under § 302(b) (1) ("not essentially equivalent to a dividend") on the ground that all the facts and circumstances demonstrated that the stock owned by other members of the stockholder's family was not subject to his control? See the first sentence of § 302(b) (5). The Senate Report (p. 233) states "In general, under [§ 302(b)] your committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under section 115(g) (1) of the 1939 Code, and in addition to provide three definite standards [*i.e.*, §§ 302(b)(2),(3), and (4)] in order to provide certainty in specific instances."

As indicated above, § 302 (redemptions) and § 331(a) (2) (partial liquidations) overlap to a degree. Their separate co-existence is explained in the Senate Report as follows (p. 49)

> Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.
>
> Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in part I of this subchapter [C]. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation.

How is "existing law" simplified by separating "into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation?" Note that § 302 provides, among other things, that a "redemption shall be treated as a

*§ 302(b) (4) relates to redemptions of certain stock of railroad corporations.

distribution in part or full payment in exchange for the stock . . . if the redemption is not essentially equivalent to a dividend." § 346(a) provides, in part, that "a distribution shall be treated in partial liquidation of a corporation if . . . the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan. . . ."

Consider the effect of §§ 302 and 331(a) (2) on this problem *A* owns all the stock of a corporation; he wishes to sell out to *B*, but *B* cannot finance the entire purchase with his own funds. The corporation's assets include a substantial amount of cash and marketable securities. *A* sells part of the stock to *B*, and then the corporation redeems the rest of *A's* stock. Has either *A* or *B* received a taxable dividend? Note that if part of *A*'s stock had been redeemed while he was the sole stockholder, the redemption would probably have been essentially equivalent to a dividend, and if *B* had borrowed enough money to buy all the stock and then had caused the corporation to redeem enough to enable him to pay off the loan, the redemption would probably have been taxed as a dividend. See *Zens* v *Quinlivan*, — F.2d — (6th Cir. 1954), *Edenfield* v. *Commissioner*, 19 T C. 13 (1952); First, "Use of Corporate Funds to Buy Out Shareholders — Acquisitions by Third Parties," *12th Annual N.Y.U. Inst. on Fed. Taxation* 191 (1954); Note, "Income Tax Problems in the Use of Stock Redemptions to Purchase a Corporation Out of Future Earnings," 67 *Harv. L. Rev.* 1387 (1954); Redlich, "The Sale of a Closely-Held Corporate Business," 9 *Tax L. Rev.* 354 (1954).

2. Section 317(b) defines redemption. By specifically including a transaction in which reacquired stock is held in the corporate treasury, it clears up a problem under § 115(g) of the 1939 Code, which spoke of a "cancellation" or "redemption" of stock. The Court of Appeals for the Second Circuit expressed the view that treasury shares have not been cancelled or redeemed, *Kirschenbaum* v. *Commissioner*, 155 F 2d 23 (2d Cir. 1946) cert. den. 329 U.S. 726. The Court of Appeals for the Seventh Circuit agreed, *Commissioner* v. *Snite*, 177 F.2d 819 (7th Cir. 1949), but the Fourth Circuit was contra.

> If it should be held that taxpayers can avoid the terms of the statute by the simple device of selling their stock to the corporation and having it held as treasury stock, the purpose of the statute to prevent the evasion of taxes upon corporate dividends would be completely frustrated. (*Wall* v. *United States*, 164 F.2d 462, 465 (4th Cir. 1947).)

An intermediate position, treating treasury shares as cancelled or redeemed where there was no intention to reissue them, was apparently approved in *Boyle* v. *Commissioner*, 187 F.2d 557 (3d Cir 1951).

Section 317(b)'s definition of redemption is clearly applicable to that term as used in § 302. But does it also apply to "redemption" as used in § 346?

3. Section 303, relating to distributions in redemption of stock to pay death taxes and funeral and administration expenses, is a liberalized version of a provision that first entered the Code in 1950, as § 115(g) (3) of the 1939 Code. If the stock of a single corporation constitutes more than 35 per cent of the value of a decedent's gross estate or more than 50 per cent of his taxable estate, a redemption of the stock up to the amount of the death taxes and funeral and administration expenses will be a capital gain or loss transaction. The stock of two or more corporations can also qualify under certain circumstances. Of course, not every redemption of an estate's stock would be a taxable dividend under § 302 even in the absence of § 303, recourse to the latter section will be necessary only if without it the distribution would be a dividend. For an estimate of the need for a provision of this type, see Harriss, "Estate Taxes and the Family Owned Business," 38 *Calif. L. Rev.* 117 (1950). The details of § 115(g) (3) of the 1939 Code are discussed in Dean, "The New Section 115(g) Regulations," *11th Annual N.Y.U. Inst. on Fed. Taxation* 587 (1953).

4. Section 304 is derived from § 115(g) (2) of the 1939 Code, enacted in 1950 to overrule *Wanamaker Trust* v. *Commissioner*, 11 T.C. 365 (1948), affirmed p.c. 178 F.2d 10 (3d Cir. 1949), which held that § 115(g) did not apply to an acquisition by a wholly owned subsidiary of stock in the parent corporation. By virtue of changes in 1954, this

section now covers redemptions by one corporation of the stock of a wider range of related corporations, as well as parent-subsidiary redemptions

5. Sections 302 and 346 both speak of a redemption of "stock." The retirement of bonds and other evidences of indebtedness is ordinarily a capital gain or loss transaction by virtue of § 1232, and there is no counterpart of § 302 to treat the retirement of such creditor instruments as a distribution of earnings and profits. Once more (see *supra*, p. 481) we find the Internal Revenue Code smiling on the issue of debt instruments instead of stock by the newly organized corporation, § 1232 is a channel through which corporate profits may be withdrawn without being classified and taxed as dividends. But the same criteria that turn ostensible bonds or debentures into stock so as to deny the deduction for so-called interest may also require the "bonds" to be treated as "stock" under § 302. *Supra*, pp. 481-2; Schlesinger, "'Thin' Incorporations: Income Tax Advantages and Pitfalls," 61 *Harv. L. Rev.* 50, 78-86 (1947).

6. When a taxpayer receives an ordinary dividend, the basis of his shares is unaffected by the receipt, and gain or loss on a subsequent disposition of the shares is calculated accordingly. But if he gets a § 302(d) dividend, he no longer has the shares for a later sale or other disposition. What happens to his basis? If it is lost, a § 302(d) distribution is not the equivalent of an ordinary dividend, it is worse than one. See Katcher, "The Case of the Forgotten Basis. An Admonition to Victims of Internal Revenue Code Section 115(g)," 48 *Mich. L. Rev.* 465 (1950).

7. Section 306, dealing with the redemption of certain classes of stock (primarily preferred stock issued as a stock dividend), is dealt with *infra*, pp. 535-6.

Section G. Distributions In Kind

1. *The "Court Holding Co." Problem*

> *Note:* **Section 337 of the 1954 Code, providing for the nonrecognition of gain or loss by a corporation on certain sales and exchanges, has no counterpart in the 1939 Code.**
>
> **Section 336 is also new in the 1954 Code, but it is based on a provision in Regs. 118, Sec. 39.22(a)-20.**

COMMISSIONER v. COURT HOLDING CO.

Supreme Court of the U.S., 1945
324 U.S. 331

MR. JUSTICE BLACK delivered the opinion of the Court.

An apartment house, which was the sole asset of the respondent corporation, was transferred in the form of a liquidating dividend to the corporation's two shareholders. They in turn formally conveyed it to a purchaser who had originally negotiated for the purchase from the corporation The question is whether the Circuit Court of Appeals properly reversed the Tax Court's conclusion that the corporation was taxable under Section 22 of the Internal Revenue Code [1] for the gain which accrued from the sale. The answer depends upon whether the findings of the Tax Court that the whole transaction showed a sale by the corporation

[1] Profits from the sale of property are taxable as income under Section 22(a) of the Internal Revenue Code. The Treasury Regulations have long provided that gains accruing from the sales of a corporation's assets, in whole or in part, constitute income to it, but that a corporation realizes no taxable gain by a mere distribution of its assets in kind, in partial or in complete liquidation, however much they may have appreciated in value since acquisition. Regs. 118, Sec. 39.22(a)-20.

rather than by the stockholders were final and binding upon the Circuit Court of Appeals.

It is unnecessary to set out in detail the evidence introduced before the Tax Court or its findings. Despite conflicting evidence, the following findings of the Tax Court are supported by the record:

The respondent corporation was organized in 1934 solely to buy and hold the apartment building which was the only property ever owned by it. All of its outstanding stock was owned by Minnie Miller and her husband. Between October 1, 1939 and February, 1940, while the corporation still had legal title to the property, negotiations for its sale took place. These negotiations were between the corporation and the lessees of the property, together with a sister and brother-in-law. An oral agreement was reached as to the terms and conditions of sale, and on February 22, 1940, the parties met to reduce the agreement to writing. The purchaser was then advised by the corporation's attorney that the sale could not be consummated because it would result in the imposition of a large income tax on the corporation. The next day, the corporation declared a "liquidating dividend," which involved complete liquidation of its assets, and surrender of all outstanding stock. Mrs. Miller and her husband surrendered their stock, and the building was deeded to them. A sale contract was then drawn, naming the Millers individually as vendors, and the lessees' sister as vendee, which embodied substantially the same terms and conditions previously agreed upon. One thousand dollars, which a month and a half earlier had been paid to the corporation by the lessees, was applied in part payment of the purchase price. Three days later, the property was conveyed to the lessees' sister.

The Tax Court concluded from these facts that, despite the declaration of a "liquidating dividend" followed by the transfers of legal title, the corporation had not abandoned the sales negotiations, that these were mere formalities designed "to make the transaction appear to be other than what it was," in order to avoid tax liability. The Circuit Court of Appeals drawing different inferences from the record, held that the corporation had "called off" the sale, and treated the stockholders' sale as unrelated to the prior negotiations.

There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. *Dobson* v. *Commissioner of Internal Revenue*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248, *Commissioner of Internal Revenue* v. *Heininger*, 320 U.S. 467, 64 S. Ct. 249, 88 L. Ed. 171, *Commissioner of Internal Revenue* v. *Scottish American Investment Co.*, 323 U.S. 119, 65 S. Ct. 169. On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, *Comp. Gen. Laws of Florida,* 1927, vol. 3, Sec. 5779, F.S.A. § 725.01. But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation. The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed.

It is so ordered.

Reversed.

Note

1. Note that the Court Holding Company is without assets to pay the tax that the Court finds to be due. It must therefore be paid by those who rendered the corporation insolvent, *viz.*, the stockholders. In effect, they overpaid their personal tax in the year the assets were distributed, since they calculated their gain on the liquidation without allowing for the corporation's tax liability. The Supreme Court has held that the proper adjustment is a capital loss in the year the transferee stockholders pay up the liquidated corporation's liability. *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952). This rule is qualified by § 1341 of the 1954 Code.

2. The Commissioner asserted a fraud penalty, which was expunged by the Tax Court with the statement

> If the petitioner here was of the opinion that the method by which it attempted to effect the sale in question was legally sufficient to avoid the imposition of tax upon it, its adoption of that method is not subject to censure. Petitioner took a position with respect to a question of law, the substance of which was disclosed by the statement endorsed on its return. (2 T.C. 531, 541–542 (1943).)

The statement on the corporation's return was

> This corporation declared a dividend in kind in complete liquidation of all of its assets to its stockholder on February 23, 1940 The property was sold on April 1, 1940, the corporation collecting the rents to the date of sale by the stockholder only. (*Id*, 534.)

3. See Regs. 118, Sec. 39.22(a)-20, providing.

> When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes . . Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss.

U. S. v. CUMBERLAND PUBLIC SERVICE CO.

Supreme Court of the U.S, 1950

338 U.S. 451

MR. JUSTICE BLACK delivered the opinion of the Court.

A corporation selling its physical properties is taxed on capital gains resulting from the sale.[1] There is no corporate tax, however, on distribution of assets in

[1] 26 U.S.C. § 22(a), Treas. Reg. 118, § 39.22(a)-18.

kind to shareholders as part of a genuine liquidation.[2] The respondent corporation transferred property to its shareholders as a liquidating dividend in kind. The shareholders transferred it to a purchaser. The question is whether, despite contrary findings by the Court of Claims, this record requires a holding that the transaction was in fact a sale by the corporation subjecting the corporation to a capital gains tax.

Details of the transaction are as follows. The respondent, a closely held corporation, was long engaged in the business of generating and distributing electric power in three Kentucky counties. In 1936 a local cooperative began to distribute Tennessee Valley Authority power in the area served by respondent. It soon became obvious that respondent's Diesel-generated power could not compete with TVA power, which respondent had been unable to obtain. Respondent's shareholders, realizing that the corporation must get out of the power business unless it obtained TVA power, accordingly offered to sell all the corporate stock to the cooperative, which was receiving such power. The cooperative refused to buy the stock, but countered with an offer to buy from the corporation its transmission and distribution equipment. The corporation rejected the offer because it would have been compelled to pay a heavy capital gains tax. At the same time the shareholders, desiring to save payment of the corporate capital gains tax, offered to acquire the transmission and distribution equipment and then sell to the cooperative. The cooperative accepted. The corporation transferred the transmission and distribution systems to its shareholders in partial liquidation. The remaining assets were sold and the corporation dissolved. The shareholders then executed the previously contemplated sale to the cooperative.

Upon this sale by the shareholders, the Commissioner assessed and collected a $17,000 tax from the corporation on the theory that the shareholders had been used as a mere conduit for effectuating what was really a corporate sale. Respondent corporation brought this action to recover the amount of the tax. The Court of Claims found that the method by which the stockholders disposed of the properties was avowedly chosen in order to reduce taxes, but that the liquidation and dissolution genuinely ended the corporation's activities and existence. The court also found that at no time did the corporation plan to make the sale itself. Accordingly it found as a fact that the sale was made by the shareholders rather than the corporation, and entered judgment for respondent. One judge dissented, believing that our opinion in *Court Holding Co.* v. *Com'r*, 324 U.S. 331, 65 S. Ct. 707, 708, 89 L. Ed. 567, required a finding that the sale had been made by the corporation. Certiorari was granted, 338 U.S. 846, 70 S. Ct. 88, to clear up doubts arising out of the *Court Holding Co.* case.

Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the cor-

[2] ". . . No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. . . ." Treas. Reg. 118, § 39.22(a)-20.

poration. The terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability. The Circuit Court of Appeals took a different view of the evidence. In this Court the Government contended that whether a liquidation distribution was genuine or merely a sham was traditionally a question of fact. We agreed with this contention, and reinstated the Tax Court's findings and judgment. Discussing the evidence which supported the findings of fact, we went on to say that "the incidence of taxation depends upon the substance of a transaction" regardless of "mere formalisms," and that taxes on a corporate sale cannot be avoided by using the shareholders as a "conduit through which to pass title."

This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution.[3] While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes. The corporate tax is thus aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasions, even where the cash proceeds are at once distributed in liquidation.[4] But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation.

Here, on the basis of adequate subsidiary findings, the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.

The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed

[3] What we said in the Court Holding Co case was an approval of the action of the Tax Court in looking beyond the papers executed by the corporation and shareholders in order to determinate whether the sale there had actually been made by the corporation. We were but emphasizing the established principle that in resolving such questions as who made a sale, fact finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves. See, *e.g.*, Helvering v. Clifford, 309 U.S 331, 335–337, 60 S. Ct 554, 556–557, 84 L Ed. 788, Commissioner of Internal Revenue v. Tower, 327 U S. 280, 66 S. Ct. 532, 90 L. Ed. 670, 164 A.L R. 1135.

[4] It has also been held that where corporate liquidations are effected through trustees or agents, gains from sales are taxable to the corporation as though it were a going concern. See, *e.g.*, First Nat'l Bank of Greeley, Colorado v. United States, 10 Cir, 86 F.2d 938, 941; Treas. Reg. 118, § 39.22(a)–20.

if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Again, if these stockholders had succeeded in their original effort to sell all their stock, their interest would have been transferred to the purchasers just as effectively. Yet on such a transaction the corporation would have realized no taxable gain.

Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.* case we accept the ultimate findings of fact of the trial tribunal. Accordingly the judgment of the Court of Claims is affirmed.

Affirmed.

MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case.

Note

Note that the respondent's shareholders offered to sell their stock to the potential vendee. What tax and non-tax reasons might cause the vendee to refuse to buy stock and to insist instead upon purchasing the assets? If the vendee *had* bought the stock, and had promptly liquidated the corporation, would the sellers have been protected against the possibility of a double tax? Note that the buyer might have relied on the *Kimbell-Diamond* line of cases, *supra*, p. 493, to establish that the transaction was "really" a purchase of assets rather than a purchase of stock. If this assertion was accepted, would it follow that the liquidated corporation had sold its assets? And if so, who must pay the tax that the liquidated corporation is unable to pay? See Magill, "Sales of Corporate Stock or Assets," 47 *Col. L. Rev.* 707 (1947).

UNITED STATES v. LYNCH

U.S. Court of Appeals, Ninth Circuit, 1951
192 F.2d 718, cert den. 343 U.S. 934 (1952)

Before MATHEWS, ORR and POPE, Circuit Judges

ORR, Circuit Judge.

We have for determination two appeals. In the first the United States of America, hereinafter referred to as the Government, is appellant, and P. J. Lynch is appellee. In the second P. J. Lynch is appellant, and the United States of America is appellee.

We first consider the appeal of the Government. It concerns the correctness of a determination made by the Commissioner of Internal Revenue, that the net proceeds of profits from the sale of apples, which the Washington Fruit and Produce Company, a corporation had attempted to distribute to its stockholders as a dividend in kind, was taxable to the corporation.

Lynch is one of several stockholders to whom a dividend in kind was issued by the Washington Fruit and Produce Company, a corporation, to which we hereinafter refer as the corporation. This dividend consisted of 21,977 boxes of apples.

The corporation at that time had three stockholders and was engaged in the business of growing, handling, warehousing and marketing of fresh fruits and vegetables. The dividend in kind was declared February 28, 1944. The apples distributed as a dividend were on that date owned and held by the corporation in its warehouse. At the same meeting at which the dividend was declared, the shareholders agreed among themselves to pool the apples and entered into an agreement with the corporation to dispose of the apples and account to the shareholders for the net proceeds after deducting the costs of washing, packing and storing. During April 1944 the apples were sold and the proceeds distributed. Possession of the apples was retained by the corporation and the sale thereof accomplished without difficulty, the state of the market being such that solicitation by the corporation for buyers was unnecessary. On April 29, 1944 the corporation was liquidated. The Commissioner held that the excess of the sale price of the apples above cost to the corporation was corporate income. The trial court found otherwise We think its finding was clearly erroneous for the following reasons. The dividend was not, nor was it intended to be, a liquidating dividend made in the process of winding up corporate affairs. The trial court found the dividend to be an ordinary one, reported as ordinary income by the recipients. The corporation continued to engage in its normal business for a period of two months after the dividend declaration. We are, therefore, required to regard the dividend under consideration here as one declared by a going concern and, inasmuch as the corporation, among other things, was engaged in the business of selling apples the property distributed represented its inventory or stock in trade.

It is clear that the shareholders caused the dividend to be declared with the knowledge and expectation that the property distributed would be sold immediately. Furthermore, the simultaneously executed agreement with the corporation to do the selling manifested a purpose on the part of the shareholders to use the corporate agency as the vehicle to effectuate the sale of apples. The corporation was to sell the apples in the normal course of its business, in essentially the same manner, and it is fair to assume to the same persons to whom it would have sold had there been no dividend declared. Under these circumstances we fail to see a motive for the dividend other than to escape taxation. It is fundamental that,

> . . in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.[1]

The dividend in question was not the kind of a distribution contemplated by the statute, § 115(a) of the Internal Revenue Code, and must be ignored for tax purposes. Distribution of corporate inventory with the expectation of immediate sale by the shareholders pointedly suggests a transaction outside the range of normal commercially-motivated and justifiable corporate activity, yet we have here a stronger case, because the sale was to be made by utilizing the corporation's facilities in the ordinary course of its business; the shareholders did not engage in a separate and independent business in which the apples were to be used. The

[1] C I R. v. Transport Trading & Terminal Corp, 2 Cir., 1949, 176 F 2d 570, 572, certiorari denied 338 U S 955, 70 S. Ct. 493, 94 L.Ed. 589.

shareholders, under the circumstances of this case, cannot avoid payment of the price Congress has decreed must be paid for use of the corporate entity.

In its opinion the trial court used language indicating its belief that the doctrine announced in *Court Holding Co.* v. *C.I.R.* 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 567, required a finding in the instant case that the sale was made by the shareholders. The *Court Holding Company* case, as well as the case of *Cumberland Public Service Co.* v. *U. S.*, 338 U.S. 451, 70 S. Ct. 280, 282, 94 L. Ed. 251, dealt with liquidating dividends and not, as here, with a dividend in kind by a going concern. In the *Cumberland* case the Supreme Court points out that "The corporate tax is thus aimed primarily at the profits of a going concern." Hence, in determining the "factual category" in which the present transaction belongs the factor of the going concern is most important. In the instant case, at the time the transaction was planned and executed all concerned knew that no necessity existed for the corporation to engage in prior negotiations and solicitations for sale of the apples because of available ready market. The record discloses that the corporation gave the shareholders most favored customer treatment by not charging a selling commission and, in addition, certain customary handling charges were not imposed. These circumstances constitute grounds for attributing the sale to the corporation. . . .

Note

1 Section 337 of the 1954 Code provides a statutory rule to govern this much-litigated area. Neither gain *nor loss* is recognized by the corporation on sales or exchanges to which § 337 applies. If the stockholders want the loss on certain property to be recognized by the corporation, what can they do to avoid the application of § 337(a)?

Note that § 337(a) does not apply to the corporation's stock in trade (unless sold in bulk), nor does it apply to a liquidation under § 333 (where the stockholders of the corporation elect not to recognize gain on the liquidation, *supra*, p. 493) or under § 341 (collapsible corporations), or to certain liquidations under § 332 (liquidations of subsidiary corporations without recognition of gain or loss, *supra*, p. 493). Section 337(a) is also inapplicable to property distributed in a *partial* liquidation What is the relation of the *Court Holding Co.* case to sales of corporate property in these excluded situations?

2. With the *Lynch* case, see *Commissioner* v. *Carter*, *supra*, p. 442, and *Commissioner* v. *First State Bank of Stratford*, *infra*, p 517.

3. See generally Cary, "The Effect of Taxation on Selling Out a Corporate Business For Cash," 45 *Ill. L. Rev.* 423 (1950), and authorities there cited.

2. *The "General Utilities" Case*

> ***Note:*** **Section 311 of the 1954 Code, relating to the effect of a distribution of property on the income of the distributing corporation, has no counterpart in the 1939 Code.**
>
> **Section 336 of the 1954 Code, relating to the effect of a distribution in partial or complete liquidation on the distributing corporation, is also new, but it is derived from Regs. 118, Sec. 39.22(a)-20.**

In the *Court Holding Co.* line of cases, the Treasury sought to tax the corporation by attributing to it a sale made in form by the stockholders. Is there a broader basis for regarding the gain as realized by the corporation? The case that follows

involved certain securities that had cost a corporation less than $2,000 and that were distributed in kind when worth more than $1 million. They were sold by the stockholders shortly after the distribution. The Treasury advanced three arguments for taxing this appreciation in value to the corporation. The first, upon which the Treasury relied in the Board of Tax Appeals, was that the corporation realized income by declaring a dividend of $1 million and then satisfying the indebtedness thus created by distributing the securities. This view was rejected by the Board of Tax Appeals. Secondly, before the Court of Appeals, the Treasury added the *Court Holding Co.* argument, *viz.*, that the shareholders were a conduit through which the assets were sold by the corporation. On this point, the Court of Appeals agreed with the Treasury. The Supreme Court granted certiorari. There the Treasury added a third argument

> It is not open to doubt that the phrase "sale or other disposition" connotes a transfer by which a gain is realized or a loss is sustained, and one of the principal reasons for rejecting the suggestion that a dividend distribution is a "disposition" has been the circumstance that the stockholders pay no consideration to the corporation, and hence there is no actual receipt of gain in a tangible form. We think that this reasoning misses the point, for in making it available to its own stockholders the corporation is realizing the appreciation, and nothing more is necessary. It is our view that the addition to surplus on account of the increased value and the distribution of this increased value in satisfaction of the company's general liability to its stockholders, are the evidence that the gain has been realized, for it is incomprehensible how a corporation can distribute to its stockholders something which it has not itself received. Petitioner had an earned surplus equivalent to the value of the stock distributed. . . . It is clear that petitioner used the increased value for a corporate purpose, and was thereby enabled to pay its stockholders $1,071,426.25. Thus was petitioner serving the principal end for which it was organized—to earn profits which it could distribute to its stockholders—and we submit that in so justifying the hopes of its organizers this economic entity, called a corporation, truly derived an economic gain. (Respondent's brief, 17–19, 25.)

It should be noted that if this third argument were accepted, the appreciation in the value of the distributed property would be taxed to the corporation even if it were conceded that the sale of the property was made by the stockholders and not by the corporation. Indeed, a sale of the distributed property would not be necessary; the distribution itself, it is contended, constitutes a realization of income by the corporation.

GENERAL UTILITIES & OPERATING CO. v. HELVERING

Supreme Court of the U.S., 1935
296 U.S. 200

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court. . . .

Both tribunals below rightly decided that petitioner derived no taxable gain from the distribution among its stockholders of the Islands Edison shares as a dividend. This was no sale; assets were not used to discharge indebtedness.

The second ground of objection, although sustained by the court, was not presented to or ruled upon by the Board. The petition for review relied wholly upon the first point; and, in the circumstances, we think the court should have considered no other. Always a taxpayer is entitled to know with fair certainty the

basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised.

Recently (April, 1935) this court pointed out: "The Court of Appeals is without power on review of proceedings of the Board of Tax Appeals to make any findings of fact." "The function of the court is to decide whether the correct rule of law was applied to the facts found, and whether there was substantial evidence before the Board to support the findings made." "If the Board has failed to make an essential finding and the record on review is insufficient to provide the basis for a final determination, the proper procedure is to remand the case for further proceedings before the Board." "And the same procedure is appropriate even when the findings omitted by the Board might be supplied from examination of the records." *Helvering* v. *Rankin*, 295 U.S. 123, 131, 132.

Here the court undertook to decide a question not properly raised. Also it made an inference of fact directly in conflict with the stipulation of the parties and the findings, for which we think the record affords no support whatever. To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause.

The judgment of the court below must be reversed. The action of the Board of Tax Appeals is approved.

Reversed.

Note

1. On the first point, there is authority for treating appreciation or depreciation as realized on a distribution if the dividend resolution creates a debt to the shareholders. *Bacon-McMillan Veneer Co.* v. *Commissioner*, 20 B.T.A. 556 (1930) (gain), *Callanan Road Improvement Co.* v. *Commissioner*, 12 B.T.A. 1109 (1928) (loss). These cases were held by the Board of Tax Appeals to be inapplicable to the General Utilities & Operating Co. distribution because the dividend resolution was interpreted as declaring a dividend of property only, rather than a dividend of a specified amount of money.

2. Although the Supreme Court did not pass on the Treasury's argument that the distribution itself constituted a realization of the appreciation by the corporation, this case was often cited as rejecting the argument. See, however, *R. D Merrill Co.* v. *Commissioner*, 4 T.C. 955, 961 (1945).

3. Section 336 of the 1954 Code gives statutory sanction to the rule, formerly expressed only in the regulations, that no gain or loss is to be recognized by a corporation on the distribution of property in partial or complete liquidation. Regs. 118, Sec. 39.22(a)-20 (which used the term "realized" rather than "recognized"). The Senate Report does not disclose whether the term "partial liquidation" as used in § 336 is restricted to distributions that reflect a contraction of the corporation's business. See *supra*, p. 504. Under the pre-1954 law, the term as used in the regulations probably embraced any redemption or cancellation of stock.

Section 311, derived from the *General Utilities & Operating Co.* case (or from the common understanding of its meaning), provides that no gain or loss shall be recognized by a corporation on a distribution of property, except for a distribution of "LIFO inventory" (*infra*, p. 683) or of property whose adjusted basis is less than the liability (if any) to which it is subject or which is assumed by the shareholder in connection with the distribution. Why is income to be recognized on these distributions? What is the relation of §§ 311(b) and (c) to §§ 1001 and 61(a)? Do §§ 311(b) and (c) require the corporation to recognize income on unrealized appreciation in the value of property, see *Eisner* v. *Macomber*, *supra*, p. 51?

4. Section 312(a)-(c) clarifies the effect of a distribution in kind upon the earnings and profits of the distributing corporation, a previously baffling problem. See *Godley's*

Estate v. *Commissioner*, 213 F.2d 529 (3d Cir. 1954); *Commissioner* v. *Hirshon Trust*, 213 F.2d 523 (2d Cir. 1954); Molloy, "Some Tax Aspects of Corporate Distributions in Kind," 6 *Tax L. Rev.* 57, 69–76 (1950).

FIRST STATE BANK OF STRATFORD v. COMMISSIONER

U S. Court of Appeals, Fifth Circuit, 1948
168 F.2d 1004, cert. den. 335 U. S. 867

Before SIBLEY, HUTCHESON, HOLMES, McCORD, WALLER, and LEE, Circuit Judges.

HOLMES, Circuit Judge:

The Commissioner is seeking the correction of errors alleged to have been made by the Tax Court in its decision in this case. The question for decision is whether certain recoveries on notes in 1942 were income to the taxpayer, the respondent on review.

On October 17, 1942, the First State Bank of Stratford declared a dividend in kind, which consisted of certain notes that had been charged off as wholly worthless, and deducted as bad debts in its income-tax returns for years previous to 1942. These notes did not appear on the bank's books. They had been kept in a case by themselves, but were brought to the directors' meeting on the above date, when the possibility of their collection was discussed. It then appeared that collections on the notes were currently being made, about $25,000 already having been collected. The payment of a dividend by the bank was next considered Attention was called to the matter of increased taxes and the advisability of deferring a cash dividend until more would be known about the new income-tax law soon to be enacted. It was pointed out that the bank had a number of charged-off accounts of doubtful value, also real estate carried on the books at the nominal sum of one dollar. The advisability of paying a dividend in these properties was fully considered, and the following resolution adopted:

> Whereas, This bank is the owner of several thousand dollars of charged off notes, some of which may be collected in future, and the balance of which are of doubtful value.
>
> Now, Therefore, Be it resolved that the following charged off notes be assigned to the stockholders of this bank without recourse on it, said notes being paid as a dividend in kind and without any value being placed thereon by this bank. (A list and description of the notes followed.)

After the meeting the directors, as stockholders, further discussed the matter. It was suggested, with approval, that W. N. Price take charge of the notes for the stockholders. Within the next few days, the notes included in the dividend were endorsed to W. N. Price without recourse on the bank. Amounts thereafter collected in 1942 on the dividend notes were deposited in the bank in an account designated "W. N. Price, Special." In attempting collection of these notes. Price, who worked in the bank, did nothing that he did not do in collecting notes owed to the bank, except at various times he worked after banking hours. No system of bookkeeping for the notes was set up by the stockholders in 1942. The debtors were not notified of the assignment of their debts to the stockholders. The notes when paid were marked paid with a stamp on which appeared the bank's name, but not the stockholders'.

After October 17, 1942, and prior to January 1, 1943, collections amounting to $11,662.71 were made on these dividend notes, of which the sum of $10,548.20 was determined by the Commissioner to be taxable income of the respondent on the theory that to this extent the distribution of the dividend in kind merely represented an assignment of anticipated income, because a tax benefit * had been received for it in prior years. The Tax Court reversed the Commissioner's determination, and held that the amounts so collected were not taxable to the respondent as income.

The taxpayer relies upon *General Utilities Co.* v. *Helvering*, 296 U.S. 200, as authority that a corporation does not realize income by its distribution of a dividend in kind. It contends that collections made on notes subsequent to their distribution as a dividend in kind are not taxable to the corporation that distributed the dividend but to their legal owners, who in this instance are the stockholders. The Commissioner argues that, having recovered its capital investment in the notes through the allowance of bad-debt deductions, the taxpayer in declaring and distributing the dividend in 1942 made an anticipatory assignment of the bank's right to collect the income represented by the notes, and was taxable on the amounts collected.

The Commissioner cites *Helvering* v. *Horst*, 311 U.S. 112, and *Helvering* v. *Eubank*, 311 U.S. 122, as to the realization and enjoyment of taxable income After stating the issues before it, the Tax Court in its opinion said

We have here, on its face, a dividend in kind which under the settled law indicated in the *General Utilities & Operating Co.* case, *supra*, is no ground for realization of taxable income, and our problem therefore is: Does the fact of previous charge-off, as worthless, of the notes involved, distinguish that case? We do not think so. Though it is true that the *National Bank of Commerce of Seattle* case [115 F.(2d) 875] . . . states ". . . that after the loans there involved were charged off and deducted from income, they were no longer a capital asset but represented income," yet it was held that when they were transferred to another bank, in a non-taxable reorganization, recoveries thereafter made were income within the broad meaning of section 22(a), Internal Revenue Code, . . . the transferee having the same basis of zero which the transferor had after the charge-off and deduction from income. Here instead of transfer in a reorganization, we find a transfer in a dividend in kind, and the *National Bank of Commerce* case seems to us recognition of the principle that despite their nature as representing income after deduction by the transferor bank, such loans nevertheless are subject to transfer as property and may constitute income to the transferee. The *Horst* and *Eubank* cases, *supra*, do not help the respondent That line of authority involves transfers of rights to income, without consideration, where it was denied that the transferor was freed from tax. Here it can not be said that there was assignment of the notes for no consideration. Distribution of a dividend in kind to stockholders is not gift, and is not without consideration—which appears inherent in the original cost of the stock upon which the dividend in kind is received. We think the logic of the *Horst* and similar cases is not applicable here. (8 Tax Court 831.)

We think we are bound under the *Dobson* rule by the decision of the Tax Court as to the reality and good faith of the dividend declaration, and as to the finding that the stockholders were owners of the notes after the assignment; but the facts are undisputed that these notes had been charged off as worthless, and that income-tax deductions had been taken for them by the respondent in prior years. Therefore, an issue of law is presented as to whether or not for all purposes of income-

* See *infra*, p. 757. [Ed.]

tax accounting, these notes ceased to be capital assets of the bank and became purely potential income, which when assigned to and collected by the stockholders was required to be included in respondent's gross income. Another way of stating the question of law is: Does the fact that the notes were distributed as a dividend in kind preclude the treatment of the transaction as an assignment of anticipatory income? The ultimate legal question is: What are the tax consequences of a dividend in kind that admittedly was intended to effect and did effect an anticipatory assignment of future corporate income?

It is well settled that, when a deduction for income-tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year. Thus, when the tax benefit for a bad debt is obtained, the debt loses its nature as capital, and becomes representative of that portion of the taxpayer's income which was not taxed. As stated in the just-cited case. "The profits or income used to pay back the capital when the debt is charged off is represented by the worthless loan, so that when such loan is paid the profits are replaced."

A dividend to a shareholder by a corporation in any medium other than money is a dividend in kind, and in a formal sense the notes here represented such a dividend. Ordinarily no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition but the rule is deemed to be otherwise where the dividend in kind is not in liquidation and consists of bad debts on account of the worthlessness of which a deduction was allowed for a prior taxable year. Whether or not the respondent corporation made an assignment of anticipatory income upon the distribution of its dividend in kind depends upon the nature of the property distributed in relation to the capital structure of the corporation. In this case, the charged-off debts no longer represented an asset except in the sense that any vested right to receive income is an asset; the notes had a basis of zero, and were no longer reflected in the capital structure of the corporation. They merely represented potential income to the extent of the tax deduction previously allowed.

The Tax Court distinguished the *Horst* and *Eubank* cases because in them the anticipatory assignments were without consideration, which is not true as to a dividend in kind. We think the question of consideration is not controlling or even important here. The question is one of the realization of income. Property may be disposed of by gift, sale, exchange, or abandonment, among which only abandonment could involve no taxable gain. The distribution of a dividend in kind is none of these. It is a delivery or assignment of property to its equitable owners. In this case, a sale or exchange of the notes would doubtless have resulted in the realization of a taxable gain, but no such disposition was required to realize income. The notes as collected would have been income to the corporation, and they were nonetheless the fruition of economic gain when collected by the assignees. It is the realization of income, rather than the acquisition of the right to receive it, that is the taxable event, and there is no reason why the rule that income tax is not to be avoided by an anticipatory assignment of income shall not apply to dividends. When not received in money or property, realization may occur when

the last step is taken by which one obtains the fruition of the economic gain.

If the bad debts stood in place of income, if the respondent was the owner of them, if it had the power to dispose of them, and if it did dispose of them to its shareholders as a dividend in kind in anticipation of their collection, all of which is conceded· the following from the opinion in *Helvering* v. *Horst, supra*, is strikingly applicable:

> The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, *Lucas* v. *Earl*, *supra*; *Burnet* v. *Leininger*, *supra*, for it was recognized in the *Leininger* case that in such a case the rendition of the service by the assignor was the means by which the income was controlled by the donor and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment, and in both cases it is the exercise of the power of disposition of the interest or compensation, with the resulting payment to the donee, which is the enjoyment by the donor of income derived from them.

If, as it has been held, there is no basis for distinguishing between the gift of interest coupons and the gift of salary or commissions, then there is none between interest coupons and notes that represent potential income. It may be said that these notes were worthless, but we know from the evidence in the record that, when the dividend in kind was declared and distributed, these formerly worthless notes had a substantial value and large sums were afterwards collected on them.[1] The income assessed in this case is less than the amounts collected on the notes during the remainder of the taxable year after the dividend was declared.

The notes were assets of the bank, and subject to transfer as other property, but they were not capital assets for income-tax purposes. The amount determined by the Commissioner to be income to the bank consisted of collections on the principal of the debts represented by the notes and perhaps of some interest that had accrued prior to the assignments. The principal was overdue and payable to the bank prior to the dividend declaration. Therefore, in declaring a dividend of the notes and assigning them without recourse, the bank assigned its vested right to receive the income that the notes represented. As the Supreme Court said in *Harrison* v. *Schaffner*, 312 U.S. 579, 581–582:

> In construing these and like provisions in other revenue acts we have uniformly held that they are not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid. See *Corliss* v. *Bowers*, 281 U.S. 376; *Lucas* v. *Earl*, *supra*, *Helvering* v. *Horst*, *supra*; *Helvering* v. *Eubank*, *supra*; *Helvering* v. *Clifford*, *supra*. It was for that reason that in each of those cases it was held that one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid.

Therefore, as a matter of law, under the anticipatory assignment-of-income rule, the respondent's declaration of a dividend, its assignment of the notes, and their subsequent collection, must be treated as if the bank had thereby realized income.

[1] As nearly as may be ascertained from the record, the face value of these notes was $111,254.38 Subsequent to the date of the assignment, Oct. 17, 1942, sixty to seventy per cent of the face value was collected by Price for the stockholders.

The facts indisputably show that the bank was making collections on these notes and declared a dividend only of the notes on which it was expected collections would be made. Over $11,000 was collected in the two-and-a-half months of the taxable year remaining after the dividend declaration. The collections were made at the bank by an officer of the bank. No pro rata distribution to stockholders was effected prior to collections, and the notes were not in any manner apportioned among the stockholders. The dividend in kind was declared and the notes assigned by the respondent with tax consequences in mind and, so far as the record shows, for no other purpose.

Like Banquo's ghost, the question that will not down is this. May a bank detach interest coupons from negotiable bonds owned by it, assign the coupons to its shareholders as a dividend in kind, and avoid the payment of income tax on the interest subsequently collected by the assignee of the coupons? In other words, by means of a dividend in kind, may a corporation avoid income taxes by doing exactly what was done (without success) by an individual by means of a gift in *Helvering* v. *Horst*, 311 U.S. 112? If so, a corporation need not ever again pay an income tax on interest derived from coupons detached from negotiable bonds. To paraphrase, and apply to the instant case, the language of the court in the above case Even though the bank never received the money, it derived money's worth from the disposition of the notes which it used in place of money in procuring a satisfaction that was procurable only by the expenditure of money or money's worth The enjoyment of the economic benefit was realized as completely as it would have been if the bank had collected the notes in dollars and cents and paid the money as a dividend to its shareholders. To say that a bank, which has declared a dividend in kind consisting of notes representing interest or earnings, subsequently paid to its shareholders, has not enjoyed or realized the fruits of its investment or labor, because it has assigned the notes instead of collecting them itself and then paying the proceeds over to its shareholders, "is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws." 311 U.S. 117–118

The avoidance of taxes may be perfectly legitimate, but it cannot be done by the anticipatory assignment of notes representing income, as a dividend in kind, and the subsequent collection of said notes by the assignees. The respondent is a banking corporation, organized and operated for profit. The acquisition of profits for its shareholders was the purpose of its creation. The collection of interest on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the "life-rendering pelican," it feeds its shareholders upon dividends. Whether they are in the form of notes or money is immaterial if the dividend is out of earnings, or consists of property purchased from earnings or which is regarded as earnings for accounting purposes. The respondent exercised its power to procure payment of its income to another, which was "the enjoyment, and hence the realization," of its income.

The distinction between *General Utilities* v. *Helvering*, *supra*, and this case lies in the difference in the character of the respective properties distributed as dividends in kind; one represented a capital asset, the other represents income. In the

former, the fruit was on the tree; in the latter, the tree itself represents fruit of prior years that was not taxed. The distinction is the same as would have existed in the *Horst* case if the father had given his son the bond with the unearned-interest coupon attached.

Consistency is essential to fairness in income-tax accounting. This is particularly true in respect to bad-debt deductions and recovery exclusions. The worthlessness of a bad debt is a question of fact; the burden of proving it is on the taxpayer. The incentive to claim it as a deduction may be tempered by the certainty that in subsequent years, if recovered, the debt will be treated not as a capital asset but as income.

There remains a question as to the correctness of the Commissioner's determination of the amount of income realized by the respondent upon the subsequent collection by the assignees of the notes distributed to them as a dividend in kind. It is contended that the tax liability, if any, should be measured by the market or intrinsic value of said notes when assigned, rather than (as the Commissioner determined) by the amounts collected less recoveries for which no tax benefit has been received.

Section 115(j) of the Internal Revenue Code [see § 301(b) (1), 1954 Code] provides that, if the whole or any part of a dividend is paid to the shareholder in any medium other than money, the property received shall be included in gross income at its fair market value as of the time that it became income to the shareholder. This paragraph relates to the value of property received by a shareholder as the distributee; it does not apply to the realization of income by the corporation that is distributing the property as a dividend. We are not here determining the tax liability of the respondent's shareholders, and therefore said paragraph is not applicable to the question before us.

To ascertain in this case the amount of income taxable to the respondent, it is necessary to inquire as to the time that the income is realized under the anticipatory-assignment doctrine. Is it when the dividend in kind is declared, when the assignment is made, or when actual payment is received by the shareholder? Mere unrealized appreciation in the value of property does not constitute taxable income; but this principle is not in conflict with the doctrine announced in the *Horst* and *Eubank* cases, in which unquestionably taxable income was involved. Unrealized appreciation, since it is not taxable income, is not covered by the rule as to anticipatory assignments of income. The latter rule is *sui generis;* it applies to debts, including bad debts, to the extent that they represent income. The acquisition of the right to receive payment of a bad debt is not necessarily a taxable event, and therefore the realization of gain by the assignor is not deemed to occur until the debt is paid to the assignee. After assignment and prior to payment the tax liability is incomplete. The rule is founded upon administrative convenience, and operates to postpone the taxable event until realization is consummated by the assignee's receipt of the money. The reasoning underlying the rule, it is said, is the thought that the "taxpayer procured the satisfaction of his wants" by diverting to others the income which he could have received himself, and that thereby he enjoyed the fruits of his labor or investment. Such use of a dividend in kind, where the property distributed represents potential income, is an economic gain to the corporation in the amounts collected less recoveries for which no tax benefit has been received.

Reversed.

SIBLEY, Circuit Judge, concurring.

I concur in the judgment of reversal and the reasoning of the majority opinion, but I wish to express an additional view which seems to me simpler and more fundamental.

It is true that a corporation which is contemplating a sale of its property by which a gain will be realized may, before anything is done by way of sale, decide to distribute the property in kind to its stockholders and escape taxation for the gain which it did not realize. This was successfully done through a dividend in kind, each stockholder receiving his share of property actually divided, in *General Utilities Co.* v. *Helvering*, 296 U.S. 200 [*supra*]. It was successfully done by a distribution to stockholders in liquidation of the corporation in *Howell Turpentine Co.* v. *Commissioner*, 162 F.2d 319. Where, however, the corporation made a contract to sell the property and afterwards called the sale off and conveyed the property to its stockholders as a liquidating dividend and the stockholders carried out the sale as made by the corporation, it was held that a finding was justified that the stockholders were in fact carrying out the corporation's sale. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331.

But the present case involves no sale by a corporation or by its stockholders, but involves the proper tax treatment of a large aggregate of debts due to the corporation which in past years the corporation, on its representation that they were bad debts and a loss, had been permitted to deduct as such with a full resulting tax benefit. This deduction was not of constitutional right, but of legislative grace, and was allowed on terms stated in applicable Regulations. Beginning in 1918 Article 52 of Regulation 45 said.

> Bad debts or accounts charged off because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off.

This language was continued down through Regulation 103, Sect. 19.42-1, under the Internal Revenue Code, when the deductions were made and allowed which are now in controversy. The restoration to income of all subsequent recoveries was a condition of the deductions. The making of this adjustment in its tax accounts with the Government became the legal and the moral duty of this corporation. When in the tax year it found it was making collections on these charged-off debts, and would likely collect considerable sums, it was not free in law or morals to evade its tax duty by turning the bad debts over to its stockholders for them to collect. The directors picked out only debts that were regarded as likely to yield collections, keeping those that were wholly bad. They did not divide them among the stockholders, but the five directors turned the hopeful debts over to one of themselves, he being vice-president and cashier of the bank, and he collected in the name of the bank, deposited the collections in the bank, and then later distributed the money to the stockholders. The stockholders returned nothing for taxation till each got his money in later years. I think there was in reality nothing divided as a dividend to the stockholders till the money was paid them, and in reality the bank made the recoveries on the charge-off debts, and the Tax Court ought to have so held. But if this were a real distribution of undivided property to the stockholders, the bank could not thus free itself of the accounting obligation which it assumed in taking the bad debt deductions. For this pur-

pose the receipt of payments by the stockholders is receipt by their corporation. All that was said in *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44, as to the force of Regulations and the ineffectualness of anticipating arrangements to evade taxes made between stockholders and their corporation, may be applied to this case. Another instance in which Regulations were held to inhere in deductions so as to require a restoration to income accordingly, though nothing was received in the tax year, is *Sneed* v. *Commissioner*, 119 F.2d 767. (Cert. denied.) This bank had no option to avoid incurring a tax by a lawful course. The course it took was not lawful because of the obligation assumed in taking the deductions with full tax benefits at the time.

JUDGES HOLMES, McCORD, and LEE also concur in the additional views expressed in the above opinion.

HUTCHESON, Circuit Judge, *dissenting*:

I agree with the conclusion of the Tax Court that the distribution to its stockholders of the notes in question was not a realization of income by it. I agree too with the reasons it gave for so concluding. I, therefore, dissent from the opinion of the majority.

WALLER, Circuit Judge, *dissenting*

I think, as did the Tax Court, that this case is controlled by *General Utilities Company* v. *Helvering*, 296 U.S. 200. I think further that even if there were some sort of tax liability to the Bank, it should be measured by the reasonable, or market, value, at the time of the making of the dividend-in-kind, of the charged-off securities, rather than by the collections thereafter made by the stockholders when improved financial conditions, increase in values, enlargement of opportunities, greater availability for refinancing of loans, such as the Court of its own knowledge knows has attended the lush period since the assignments were made, aided the makers in paying obligations which they could not have paid theretofore.

Moreover, I do not think that the doctrine in *Helvering* v. *Horst*, 311 U.S. 112, can rightly be stretched to cover this case for the chief reason that the action of the stockholders in agreeing to accept a dividend-in-kind in lieu of a dividend in a fixed percentage cannot truly be said to be without consideration. True it is that the stockholders owned the Bank, but the law does not contemplate that banks shall be one with their stockholders.

The ascertainment of the correct amount of taxes due on income actually received is already difficult and onerous enough without, through judicial processes, adding to the taxpayer's perplexity and burden by requiring him to compute and pay taxes on income merely anticipated but never received, but which has theretofore been assigned in due and lawful course of business.

I do not consider these assignments as gratuitous transfers of income already earned and readily collectible, such as characterized the interest coupons in the *Horst* case, *supra*. I, therefore, must dissent to the learned and persuasive opinion of the majority in this case.

Note

See § 311(a). The Senate Report p. 247) states:

[Y]our committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of *Commissioner* v. *First State Bank of Stratford*.

Section H. Stock Dividends and Recapitalizations

1. Stock Dividends

Note: Section 305(a) of the 1954 Code, relating to distributions by a corporation of its own stock, substantially changes § 115(f)(1) of the 1939 Code.

Section 305(b)(1), relating to distributions of stock in discharge of preference dividends, has no counterpart in the 1939 Code.

Section 305(b)(2), relating to elective distributions of stock, is derived from § 115(f)(2) of the 1939 Code.

Section 307(a) of the 1954 Code, relating to the basis of stock received tax-free, is derived from § 113(a)(19) of the 1939 Code

Section 307(b) of the 1954 Code, relating to the basis of certain stock rights, has no counterpart in the 1939 Code.

The federal income tax treatment of distributions by a corporation of its own stock (and of the rights to acquire its own stock) can be divided into four eras as follows

The first period ended with *Eisner* v. *Macomber*, *supra*, p. 51, holding that § 2(a) of the Revenue Act of 1916, taxing all stock dividends (if covered by earnings and profits) to the extent of their fair market value, was unconstitutional as applied to a distribution of common stock on common stock by a corporation having no other class of stock outstanding. *Eisner* v. *Macomber* should be reviewed at this point.

The second period began with the Revenue Act of 1921, which provided (in response to *Eisner* v. *Macomber*) that "a stock dividend shall not be subject to tax," a provision that was carried forward until the enactment of the Revenue Act of 1936. During this period the Treasury's regulations required the adjusted basis of the old stock to be allocated between the old shares and the dividend shares in the same proportion as their respective market values at the time of distribution. In *Koshland* v. *Helvering*, 298 U.S. 441 (1936), this regulation was held invalid as to a taxpayer who had received a dividend of common stock on non-voting preferred shares. No such distribution was made on the common stock. The Court reasoned that the dividend shares, unlike those in *Eisner* v. *Macomber*, gave "the stockholder an interest different from that which his former stockholdings represented." Therefore, said the Court, the shares were constitutionally taxable when received. The Court then held that the failure of Congress to tax the dividend shares did not authorize the Treasury to allocate part of the basis of the old shares to the dividend shares. Consequently the old shares retained their full basis for determining gain or loss on their disposition.

Besides making clear that *Eisner* v. *Macomber* did not immunize all stock dividends, the *Koshland* case opened up the possibility of an escape from taxation for taxpayers who had accepted the benefit of the regulation in question by allocating part of their original basis to the dividend shares on sales of those shares. It was possible that such taxpayers could claim the full original basis on a later sale of the original shares Not long after the *Koshland* case, the Court held in *Helvering* v. *Gowran*, 302 U.S. 238 (1937), that under the 1921–36 statutes the basis of dividend shares was zero, since they cost the stockholder nothing and were not taxed as income when received. This determination opened up the possibility—the converse of the possible escape from taxation under the *Koshland* case

—that a taxpayer who had complied with the invalidated regulation on selling his original shares (by allocating part of their basis to the retained dividend shares) would now have to use a zero basis on selling the dividend shares, and thus would never recover tax-free his total investment.

To counteract these possible results of the *Koshland* and *Gowran* cases, Congress in 1939 enacted § 113(a) (19) of the 1939 Code, the predecessor of § 307(a) of the 1954 Code. It adopted the rules applied under the invalidated Treasury regulation and also made provision for situations in which income on the sale of either the original or the dividend shares had been computed in a fashion inconsistent with the old regulation. Alvord and Biegel, "Basis Provisions for Stock Dividends under the 1939 Revenue Act," 49 *Yale L.J.* 841 (1940). Under § 117(h) (5) of the 1939 Code [now § 1223(5) of the 1954 Code], also enacted in 1939, the "holding period" of non-taxable dividend shares includes the period during which the original shares were held.

The third era began in 1939 when Congress, in addition to clearing up the debris left by the *Koshland* and *Gowran* cases with respect to stock dividends declared in the earlier years, went on to enact § 115(f) (1) of the 1939 Code:

A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

Did this section tender the Supreme Court an opportunity to re-examine *Eisner* v. *Macomber* or did it take that case as its starting point? In *Helvering* v. *Griffiths*, 318 U.S. 371 (1943), a majority of the Court held that § 115(f) (1) was not intended to invite a reconsideration of *Eisner* v. *Macomber;* the minority saw such an invitation, accepted it, and expressed the view that *Eisner* v. *Macomber* should be overruled. As § 115(f) (1) was interpreted by the majority, then, "the tax status of a stock dividend now [pre-1954] turns in effect on what would have been unconstitutional under *Eisner* v. *Macomber* if *Eisner* v. *Macomber* had been correct in its premise that a constitutional issue is present." Cohen, Surrey, Tarleau, and Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Stockholders," 52 *Col. L. Rev* 1, 9–10 (1952).

Just what stock dividends could be taxed under § 115(f) (1) of the 1939 Code, as thus construed, was veiled with obscurity. In *Strassburger* v. *Commissioner,* 318 U.S. 604 (1943), the Supreme Court held (by a 5–3 vote), that a distribution of a newly created issue of non-voting cumulative preferred stock by a corporation that had only common stock outstanding was not taxable. All of the common stock was owned by a single stockholder, the taxpayer, and the Court said:

While the petitioner . . . received a dividend in preferred stock, the distribution brought about no change whatever in his interest in the corporation. Both before and after the event he owned exactly the same interest in the net value of the corporation as before. At both times he owned it all and retained all the incidents of ownership he had enjoyed before.

In *Helvering* v. *Sprouse,* decided at the same time as the *Strassburger* case, the Court held that a distribution of non-voting common stock by a corporation having both voting and non-voting common outstanding was also non-taxable. The non-voting common was distributed to the holders of both the voting and the

non-voting common, but the taxpayer, before the stock dividend, owned only common stock. The government argued that the distribution came within the rule of the *Koshland* case that "where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income." But the Court (5–3) said:

> We think *Koshland* v. *Helvering*, 298 U.S. 441, 56 S. Ct. 767, 80 L Ed. 1268, 105 A.L.R. 756, distinguishable. That was a case where there were both preferred and common stockholders and where a dividend in common was paid on the preferred. We held, in the circumstances there disclosed, that the dividend was income but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.

Two more decisions under § 115(f) (1) of the 1939 Code, both involving the same distribution, are of interest. The corporation in question had 4000 shares of Class A common stock and 24,000 of Class B common outstanding, some shareholders held both classes, some held only Class B, and one held only Class A. The distribution consisted of ½ share of Class A on each share of Class A, and ½ share of Class B on each share of Class B. Because the Class A shares were entitled to a $6 dividend before any dividend could be declared on Class B, the effect of the distribution was that the Class A shareholders as a group became entitled to receive $36,000, rather than only $24,000, before the Class B shareholders could receive a dividend. There was a similar worsening in Class B's rights to a liquidating distribution.* The Tax Court held that the stock dividends were taxable. Its decision was reversed as to a stockholder who owned 2% of each class on the ground that his proportionate interest in the corporation was unchanged, because what he lost in his capacity as a holder of Class B stock he gained in his capacity as a Class A stockholder. *Tourtelot* v. *Commissioner*, 189 F.2d 167 (7th Cir. 1951), cert. den. 343 U.S. 901 (1952). When a case involving all of the other stockholders came before the Court of Appeals for the Third Circuit, it first affirmed the Tax Court, distinguishing the *Tourtelot* case because there the taxpayer held both classes in equal proportion. On reargument, however, it reversed the Tax Court, saying of the changes which the distribution effected in the priorities of the respective classes to current and liquidating distributions:

> These were practical, money-wise changes as distinguished from alterations of rights. No changes whatsoever were effected in the strict legal rights of stockholders either *vis-a-vis* each other or the corporation. (*Wiegand* v. *Commissioner*, 194 F.2d 479 (3d Cir. 1952).)

Even if one is not persuaded by this reasoning, it should be noted that the Tax Court's decision had the surprising result that the Class B stockholder, whose position was worsened by the distribution, received a taxable dividend precisely because of that detriment. For more on the pre-1954 status of stock dividends, see Lowndes, "The Taxation of Stock Dividends and Stock Rights," 96 *U. of Pa. L. Rev.* 147 (1947); Rottschaefer, "Present Taxable Status of Stock Dividends in Federal Law," 28 *Minn. L. Rev.* 106 and 163 (1944); *Schmitt* v. *Commissioner*, 208 F.2d 819 (3d Cir. 1954).

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* At higher levels of corporate income, however, the respective positions of the two classes would come into balance once more

Any hope that the constitutional limits to the taxation of stock dividends will be clearly staked out in the near future was much dampened as the 1954 Code brought on the fourth era in the taxation of stock dividends. While the courts will have to continue to wrestle with pre-1954 distributions under § 115(f) (1) of the 1939 Code, § 305(a) of the 1954 Code reinstates the 1921–36 rule that distributions by a corporation of its own stock or of rights to acquire its own stock are not taxable. See, however, the limitations of § 305(b). The corresponding basis provision, § 307(a), continues the method of allocation first established by the Treasury regulation that was invalidated by the *Koshland* case and reinstated by § 113(a) (19) of the 1939 Code. An exception, to avoid trifling basis adjustments when stock rights are received, is provided by § 307(b). Where stock rights take over (either by election under § 307(b) (2) or because § 307(b) (1) (B) is not satisfied) part of the basis of the stock with respect to which they are distributed, upon exercise their basis will be added to the cost of the stock thus acquired in determining its basis. If stock rights with a basis are allowed to lapse without exercise, the Treasury takes the position that no loss is incurred, and that the shares in respect to which the rights were issued reacquire their original basis. See Note, "Taxing Corporate Distributions of Stock or Property Warrants," 51 *Col. L. Rev.* 496 (1951), G.C.M. 25063, 47–1 C.B. 45.

By virtue of § 312(d), a non-taxable distribution of stock does not reduce the earnings and profits of the distributing corporation Moreover, under § 312(f)(2), if a corporation receives a non-taxable stock distribution from another corporation, the recipient corporation's earnings and profits are not increased thereby.

CHAMBERLIN v. COMMISSIONER

U. S. Court of Appeals, Sixth Circuit, 1953
207 F.2d 462, cert. den. 347 U. S. 918 (1954)

Before SIMONS, Chief Judge, and MCALLISTER and MILLER, Circuit Judges

MILLER, Circuit Judge.

Petitioner C. P. Chamberlin seeks a review of an income tax deficiency determined by the Respondent for the calendar year 1946, and sustained by the Tax Court. In the Tax Court the proceeding was consolidated with the proceedings of five other taxpayers similarly situated, all of which proceedings involved the same factual and legal questions. The taxpayers, all of whom were stockholders of Metal Moulding Corporation, about which this litigation centers, and their respective deficiencies were as follows:

C. P. Chamberlin	$343,650.86
Grace A. Chamberlin, his wife	63,225.55
John H. Toner	19,620.37
Benjamin James Carl	7,244.29
Guy V. Schrock	9,177.83
Robert and Josephine Pierce	14,635.19

The Tax Court upheld the deficiency assessment in each proceeding. . . .

The facts in the main are stipulated and are not in dispute. . . .

The Metal Moulding Corporation, hereinafter referred to as the Corporation, is a Michigan corporation engaged in the business of manufacturing metal mouldings and bright work trim used in the manufacture of automobiles. . . . From 1940 until December 20, 1946, the issued and outstanding common stock totaled 1,002½ shares, of which Chamberlin and his wife together owned 83.8%. . . .

The business of the Corporation prospered, and after paying substantial cash dividends over a period of years, its balance sheet at the end of the first six months in 1946 reflected total assets of $2,488,836.53 and included in current assets $722,-404.56 cash and $549,950 United States Government Bonds and notes.

On December 16, 1946, the Corporation's authorized capital stock was increased from $150,000 to $650,000, represented by 6,500 shares of $100 par value common stock. On December 20, 1946, a stock dividend was declared and distributed of five shares of common for each share of common outstanding, and the Corporation's accounts were adjusted by transferring $501,250 from earned surplus to capital account.

On December 26, 1946, the articles of incorporation were amended so as to authorize, in addition to the 6,500 shares of common stock, 8,020 shares of 4½% cumulative $100 par value preferred stock. On December 28, 1946, a stock dividend was declared of 1⅓ shares of the newly authorized preferred stock for each share of common stock outstanding, to be issued pro rata to the holders of common stock as of December 27, 1946, and the Company's accounts were adjusted by transferring $802,000 from earned surplus to capital account The preferred stock was issued to the stockholders on the same day. Prior to the declaration of the preferred stock dividend, the Corporation at all times had only one class of stock outstanding.

On December 30, 1946, as the result of prior negotiations hereinafter referred to, all of the holders of the preferred stock, except the estate of Edward W. Smith, deceased, which owned 20 shares, signed a "Purchase Agreement," with the Northwestern Mutual Life Insurance Company and The Lincoln National Life Insurance Company, which instrument was also endorsed by the Corporation for the purpose of making certain representations, warranties and agreements. Under the "Purchase Agreement" 4,000 shares of the preferred stock was sold to each of the two insurance companies at a cash price of $100 per share plus accrued dividends from November 1st, 1946 to date of delivery. Pursuant to the "Purchased Agreement" the holders of the preferred stock, with the exception of the estate of Edward W. Smith, delivered their stock certificates endorsed in blank to agents of the two insurance companies, who transferred to C. P. Chamberlin as agent for the stockholders funds for the amount of the purchase price, which Chamberlin distributed to the stockholders in proportion to their interests by delivery of his personal checks. . . .

In the latter part of 1945, the Corporation's attorney and Chamberlin discussed with an investment firm in Chicago the possibility of selling an issue of preferred stock similar to the stock subsequently issued. The Corporation had such a large accumulated earned surplus it was fearful of being subjected to the surtax provided for by Sec. 102 [§ 531 of the 1954 Code], but at the same time Chamberlin, the majority stockholder, was not willing to have the Corporation distribute any substantial portion of its earned surplus as ordinary dividends because his indi-

vidual income was taxable at high surtax rates. It was proposed that the issuance of a stock dividend to the stockholders and the sale of it by the stockholders would enable the stockholders to obtain accumulated earnings of the Corporation in the form of capital gains rather than as taxable dividends. The investment counselor contacted The Lincoln National Life Insurance Company of Fort Wayne, Indiana, and during October 1946, furnished the Insurance Company financial information relative to the Corporation. On November 7, 1946, a representative of the Insurance Company came to Detroit and made an inspection of the plant and properties of the Corporation. On November 20, 1946, The Lincoln National Life Insurance Company's finance committee approved the proposed issue and the purchase of one-half thereof. The Northwestern Mutual Life Insurance Company was contacted for the purpose of participating in the purchase of the preferred stock. It made a detailed investigation of the Corporation and of the terms and conditions of the proposed preferred stock issue, and about two weeks before December 30, 1946, its committee on investments approved the purchase of 4,000 shares of the preferred stock to be issued, and passed the matter over to its legal department for the conclusion of the transaction.

The preferred stock contained the following provisions among others: The holders were entitled to cumulative cash dividends at the rate of $4.50 per annum payable quarterly beginning November 1, 1946; the stock was subject to redemption on any quarterly dividend date in whole or in part at par plus specified premiums and accrued dividends, it was subject to mandatory retirement in amounts not exceeding 2,000 shares on May 1, 1948 and 1,000 on May 1st on each succeeding year, depending upon the Corporation's net earnings for the preceding year, until fully retired on May 1, 1954; in the event of certain defaults, of dividend payments or annual retirements, the holders were entitled to elect a majority of the directors; as long as any preferred shares remained outstanding the consent of the holders of at least 75% thereof was required to validate certain actions, including changing the articles of incorporation or capital structure, the sale of the company's property, or the incurrence of indebtedness for borrowed money in excess of a certain amount; the Corporation could not pay any cash dividend upon any stock junior to the preferred if there was any default in the payment of dividend upon and the annual retirements of the preferred, or if such dividend reduced the net working capital of the Corporation below an amount equal to 150% of the aggregate par value of all outstanding preferred, or $750,000, whichever amount was greater, or reduced the currents assets of the Company to an amount less than 200% of current liabilities. These provisions had been discussed with the Lincoln National Life Insurance Company and some of them, at least, were included in order to satisfy the investment requirements of the two insurance companies.

No agreement of purchase and sale was entered into between any of the petitioners and either of the two insurance companies prior to the "Purchase Agreement" executed on December 30, 1946, but the stockholders and directors of the Corporation took the necessary actions to put the negotiated plan into effect, as hereinabove set out, only after the insurance companies certified their willingness to participate in the purchase, if, as, and when the preferred stock was issued on the terms and conditions prescribed by them and as set out in the Company's charter as amended on December 27, 1946.

In reporting this sale of the preferred stock in their 1946 tax returns, each of

the stockholders reported his proportion of the proceeds from the sale as a net long-term capital gain from the sale of a capital asset held for more than six months, used a substituted basis as the cost basis of the preferred stock, and in determining the period the preferred stock had been held included the holding period of the common stock upon which the preferred stock dividend was declared

The Respondent ruled that the preferred stock constituted a dividend taxable as ordinary income, and further determined that the value was the amount received on the sale of the shares against which the expenses incurred in the sale were a valid deduction. This ruling resulted in the deficiency assessments involved in these consolidated proceedings.

Before considering the ruling of the Tax Court it is well to briefly review some of the Supreme Court decisions involving the taxability of stock dividends. . . .

In *Helvering* v. *Sprouse*, 318 U.S. 604, 63 S. Ct. 791, 87 L Ed. 1029, and in *Strassburger* v. *Commissioner of Internal Revenue*, 318 U.S. 604, 63 S. Ct. 791, 87 L. Ed. 1029, the Court restated the rule that in order to render a stock dividend taxable as income there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest. The rule was applied to the facts in the *Strassburger* case where preferred stock was created and distributed as a stock dividend to a stockholder who owned the entire outstanding common stock, the Court holding that the preferred stock dividend did not constitute taxable income.

The Commissioner supported his assessment on the ground that although the preferred stock was issued as a non-taxable dividend, a concerted plan to sell the dividend shares was formulated prior to the distribution of such shares, which, coupled with actual sale immediately after receipt and the payment of the proceeds of sale direct to the stockholders constituted a taxable dividend to the extent of available earnings. He also took the position that the plan and the immediate sale resulted in a change in the proportional interest of the stockholders which was sufficient to exclude it from the rulings in the Supreme Court cases above referred to. . . .

The Tax Court held that the issue of whether the stock dividend constituted income to the stockholders should be determined from a consideration of all the facts and circumstances surrounding the issuance of the dividend and not by a consideration limited to the characteristics of the stock declared as a dividend; that each case involving a stock dividend must be decided upon its own facts and circumstances as establishing whether the receipt of a particular kind of stock dividend was in fact taxable; that such a decision did not rest upon matters of form or nomenclature attending a stock dividend distribution but rather upon the real substance of the transaction involved, that disregarding the circumstances and terms of the issue it might be said that as a matter of form the stock dividend constituted one which fell within the *Strassburger* case, but that considering the real substance of the transaction it was of the opinion that the stock dividend was not in good faith for any bona fide corporate business purpose, and that the attending circumstances and conditions under which it was issued made it the equivalent of a cash dividend distribution out of available earnings, thus con-

stituting ordinary taxable income in the amount of the value of the preferred shares received. The Court also said that the real purpose of the issuance of the preferred shares was concurrently to place them in the hands of others not then stockholders of the Corporation, thereby substantially altering the common stockholders' pre-existing proportionate interests in the Corporation's net assets and thereby creating an entirely new relationship amongst all the stockholders and the Corporation. One judge concurred in the result without separate opinion; one judge concurred in a separate opinion which did not concur in the reasoning of the majority opinion, and a third judge wrote a dissenting opinion.

In our opinion, the declaration and distribution of the preferred stock dividend, considered by itself, falls clearly within the principles established in *Towne* v. *Eisner*, *supra*, and *Eisner* v. *Macomber*, *supra*, and is controlled by the ruling in the *Strassburger* case. Accordingly, as a preliminary matter, we do not agree with the Tax Court's statement that the stock dividend is taxable because as a result of the dividend and immediate sale thereafter it substantially altered the common stockholders' pre-existing proportional interests in the Corporation's net assets The sale to the insurance companies of course resulted in such a change, but the legal effect of the dividend with respect to rights in the corporate assets is determined at the time of its distribution, not by what the sockholders do with it after its receipt. In *Helvering* v. *Griffiths*, *supra*, 318 U.S. 371, at page 394, 63 S. Ct., at page 648, 87 L. Ed. 843, the Court pointed out· "at the latest the time of receipt of the dividend is the critical one for determining taxability." In none of the Supreme Court cases referred to above is it suggested that events subsequent to the distribution have any bearing on whether the stockholder's proportional interest is changed. The fact that events occur in quick succession does not by itself change their legal effect. *Biddle Avenue Realty Corp.* v. *Commissioner*, 6 Cir., 94 F.2d 435. It seems clear to us that if taxability exists it is not because of the change in pre-existing proportional interests caused by a later sale, but by reason of the other ground relied upon by the Tax Court, namely, that viewed in all its aspects it was a distribution of cash rather than a distribution of stock. That this is the real basis of the ruling appears from the statement in the opinion that "disregarding the circumstances and terms of the issue, it might be said as a matter of form the stock dividend constituted one which fell within the *Sprouse* and *Strassburger* cases. . . . However, . . , not form but the real substance of the transaction is controlling"

The general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits. . . .

It is equally well settled that this principle does not prevent the Government from going behind the form which the transaction takes and ascertaining the reality and genuineness of the component parts of the transaction in order to determine whether the transaction is really what it purports to be or is merely a formality without substance which for tax purposes can and should be disregarded. . . .

The question accordingly presented is not whether the overall transaction, admittedly carried out for the purpose of avoiding taxes, actually avoided taxes which would have been incurred if the transaction had taken a different form,

but whether the stock dividend was a stock dividend in substance as well as in form.

No question is raised about the legality of the declaration of the dividend. Respondent does not contend that proper corporate procedure was not used in creating the preferred stock and in distributing it to the stockholders in the form of a dividend. If the transaction had stopped there we think it is clear that the dividend would not have been taxable in the hands of the stockholders. *Strassburger* v. *Commissioner, supra.* Whether the declaration of the dividend was in furtherance of any corporate business purpose or was the result of correct judgment and proper business policy on the part of the management, we believe is immaterial on this phase of the case. The Supreme Court cases in no way suggest that the taxability of a stock dividend depends on the purpose of its issuance or the good or bad judgment of the directors in capitalizing earnings instead of distributing them. The decisions are based squarely upon the proportional interest doctrine. See also *Tourtelot* v. *Commissioner of Internal Revenue,* 7 Cir., 189 F.2d 167; *Wiegand* v. *Commissioner of Internal Revenue,* 3 Cir., 194 F.2d 479. In *Dreyfuss* v. *Manning, D.C.N.J.,* 44 F. Supp. 383, a stock dividend of preferred stock, declared solely for the purpose of avoiding taxes on undistributed net income, was held non-taxable, which ruling apparently was not appealed by the Commissioner. The presence or absence of a corporate business purpose may play a part in determining whether a stock dividend is a bona fide one, one in substance as well as in form, but it does not by itself change an otherwise valid dividend into an invalid one. A stock dividend, legally created and distributed, which is a dividend in substance as well as in form, does not change from a non-taxable dividend into a taxable one because of the purpose of its issuance or on account of the good or bad judgment of the directors in declaring it. *Eisner* v. *Macomber, supra,* 252 U.S. at page 211, 40 S Ct. at page 194.

Nor is there any question about the genuineness and unconditional character of the sale of the preferred stock by the stockholders who received it to the two insurance companies. The facts show conclusively that title passed irrevocably from the stockholders to the insurance companies, and that the sellers received in cash without restriction a full consideration, the adequacy of which respondent does not question. But respondent contends that the sale of the stock following immediately upon its receipt resulted in the stockholder acquiring cash instead of stock, thus making it a taxable dividend under Secs 22(a) and 115(a), Internal Revenue Code. There are two answers to this contention.

A non-taxable stock dividend does not become a taxable cash dividend upon its sale by the recipient. On the contrary, it is a sale of a capital asset. *Eisner* v. *Macomber,* 252 U.S. 189, 212, 40 S. Ct. 189; *Miles* v. *Safe Deposit & Trust Co.,* 259 U.S. 247, 42 S. Ct. 483, 66 L. Ed. 923. The rulings in those cases make it clear that its character as a capital asset is in no way dependent upon how long it is held by the taxpayer before its sale. In none of the Supreme Court cases referred to above, dealing with the taxability of stock dividends, was the length of the holding period considered as a factor. Obviously, if the non-taxability of a stock dividend rests solely upon the principle that it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holdings, the disposition of the stock dividend by the stockholder thereafter is not a

factor in the determination. See also *Insull* v. *Commissioner*, 7 Cir., 87 F.2d 648, *Silas H. Burnham*, 29 B.T.A. 605.

The foregoing conclusion is supported by Sec. 117(h)(5), Internal Revenue Code, [§ 1223(5), 1954 Code] which provides that for the purpose of determining whether a non-taxable stock dividend which has been sold is a long-term capital gain there shall be included in the holding period the period for which the taxpayer held the stock in the distributing corporation prior to the receipt of the stock dividend. This necessarily recognizes that a stock dividend will often be sold before the expiration of six months after its receipt, and makes no distinction between a stock dividend held one day or for any other period less than six months. Likewise, Sec. 39.113(a)(19)-1, Treasury Regulations 118, in establishing the cost basis of a non-taxable stock dividend which has been sold for a gain or loss, makes no distinction between a stock dividend sold immediately after receipt and one held a long period of time before sale.

The other answer to the contention is that although the stockholder *acquired* money in the final analysis, he did not *receive* either money or property *from* the corporation. Sec. 115(a), Internal Revenue Code, in dealing with taxable dividends, defines a dividend as "any distribution *made by a corporation* to its shareholders, whether in money or in other property . . . out of its earnings or profits. . . ." (Emphasis added.) The money he received was received from the insurance companies. It was not a "distribution" by the corporation declaring the dividend, as required by the statute.

We come then to what in our opinion is the dominant and decisive issue in the case, namely, whether the stock dividend, which, by reason of its redemption feature, enabled the Corporation to ultimately distribute its earnings to its stockholders on a taxable basis materially lower than would have been the case by declaring and paying the usual cash dividend, was a bona fide one, one in substance as well as in form. . . .

It seems clear that it was an issue of stock in substance as well as in form. According to its terms, and in the absence of a finding that it was immediately or shortly thereafter redeemed at a premium, we assume that a large portion of it has remained outstanding over a period of years with some of it still unredeemed after nearly seven years. It has been in the hands of the investing public, free of any control by the corporation over its owners, whose enforceable rights with respect to operations of the corporation would not be waived or neglected. Substantial sums have been paid in dividends. The insurance companies bought it in the regular course of their business and have held it as approved investments. For the Court to now tell them that they have been holding a sham issue of stock would be most startling and disturbing news.

It also seems clear that the insurance companies were not purchasers in form only without acquiring any real interest in the property conveyed. The character of the transaction as a bona fide investment on the part of the insurance companies is not challenged by the respondent. The element of a formal conduit without any business interest is entirely lacking.

If the transaction lacks the good faith necessary to avoid the assessment it must be because of the redemption feature of the stock, which, in the final analysis, is what ultimately permitted the distribution of the corporate earnings and is the

key factor in the overall transaction. Redemption features are well known and often used in corporate financing. If the one in question was a reasonable one, not violative of the general principles of bona fide corporate financing, and acceptable to experienced bona fide investors familiar with investment fundamentals and the opportunities afforded by the investment market we fail to see how a court can properly classify the issue, by reason of the redemption feature, as lacking in good faith or as not being what it purports to be. The insurance companies, conservative, experienced investors, analyzed the stock issue very carefully, provisions were required to make it conform to sound investment requirements, and each of the two companies, acting independently of the other, purchased a very substantial amount in the regular course of their investment purchases. If the redemption feature was unreasonable or not in accord with generally accepted investment principles the stock would not have been approved as an investment and purchased by the two insurance companies. In our opinion, the redemption feature, qualified as it was with respect to premiums, amounts subject to redemption in each year, and the length of time the stock would be outstanding, together with the acceptance of the stock as an investment issue, did not destroy the bona fide quality of the issue. We cannot say that the preferred stock was not in fact what it purported to be, namely, an issue of stock in substance as well as in form

Each case necessarily depends upon its own facts. The facts in this case show tax avoidance, and it is so conceded by petitioner. But they also show a series of legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be. Unless we are to adopt the broad policy of holding taxable any series of transactions, the purpose and result of which is the avoidance of taxes which would otherwise accrue if handled in a different way, regardless of the legality and realities of the component parts, the tax assessed by the Commissioner was successfully avoided in the present case. We do not construe the controlling decisions as having adopted that view. . . .

In deciding this case it must be kept in mind that it does not involve a ruling that the profit derived from the sale of the stock dividend is or is not taxable income. Such profit is conceded to be taxable. The issue is whether it is taxable as income from a cash dividend or as income resulting from a long-term capital gain. Accordingly, it is not the usual case of total tax avoidance. Congress has adopted the policy of taxing long-term capital gains differently from ordinary income. By Sec. 115(g), Internal Revenue Code, it has specifically excluded certain transactions with respect to stock dividends from the classification of a capital gain. The present transaction is not within the exclusion. If the profit from a transaction like the one here involved is to be taxed at the same rate as ordinary income, it should be done by appropriate legislation, not court decision.

The judgment is reversed and the case remanded to the Tax Court for proceedings consistent with the views expressed herein

Note

1. Section 306 of the 1954 Code is aimed squarely at the *Chamberlin* type of preferred stock "bail-out." The preferred stock received as a dividend in the *Chamberlin* case would be (if distributed after § 306 took effect) "section 306 stock" under § 306 (c)(1)(A) and § 306(c)(2). As a consequence, a sale of the preferred stock by one of the stockholders would produce ordinary income under § 306(a)(1) to the extent of the stock's share of the corporation's earnings and profits at the time it was issued.

In the *Chamberlin* case, the stock was worth $100 per share when issued and this amount was fully covered by earnings and profits, therefore, on a sale of the stock the proceeds would be ordinary income up to $100, and the balance, if any, would be taxed as a capital gain to the extent that it exceeded the stock's adjusted basis.* If "section 306 stock" is not sold but is instead redeemed by the corporation, its redemption is to be treated like an ordinary distribution, so that ordinary income will be received to the extent of the corporation's earnings and profits at the time of redemption. The proceeds of a sale, on the other hand, will be ordinary income to the extent of the stock's ratable share of earnings and profits when it was issued, even though the corporation has no earnings and profits when the stock is sold, and if the corporation has earnings and profits at that time, they are not reduced despite the fact that the shareholder is required to report ordinary income on the sale. Thus, to revert to the *Chamberlin* case, the sale of "section 306 stock" by the recipients would have been taxed as an ordinary dividend, but the corporation's earnings and profits account would not reflect this fact, and a subsequent distribution of the very earnings and profits that caused the preferred stock to be treated as "section 306 stock" will also be taxed as ordinary income to the stockholders. If they had caused the corporation to redeem their "section 306 stock," on the other hand, they would have realized ordinary income to the extent of earnings and profits at the time of redemption, but the corporate earnings and profits account would be reduced accordingly. Whether the stock is sold or redeemed, however, the adjusted basis of the "section 306 stock" will often not be recovered Compare the status of stock redeemed under § 302(d), *supra*, p. 505.

It will be noted that § 306 does not require any prearranged plan to sell the stock or to cause its redemption

The statute moderates the draconic rule of § 306(a) with several exceptions. If the stockholder disposes of his † entire stock interest in the corporation under circumstances set out in § 306(b)(1), he can avoid ordinary income treatment. A redemption of the "section 306 stock" in partial or complete liquidation will also relieve him of the special rules of § 306. With respect to this exception, § 306(b)(2), the Senate Report states (p. 243)

> In the case of a partial liquidation your committee contemplates a contraction of the corporate business so that it is immaterial that the distribution in partial contraction is with respect to section 306 stock. A bona fide contraction of the corporate business is not considered a means of distributing corporate earnings to shareholders at capital gains rates.

See *supra*, p. 504, on the relation of the term "partial liquidation" to a corporate contraction. An exchange of "section 306 stock" in a nontaxable transaction (such as a tax-free reorganization or a § 1036 exchange) is also excepted from the general rule of § 306(a), but the stock received on the exchange will ordinarily become "section 306 stock", and its disposition will be subject to the same rules that would have governed a disposition of the "section 306 stock" given up. Finally, § 306(b)(4) excepts transactions where it is established to the satisfaction of the Secretary of the Treasury that tax avoidance was not a principal purpose. This exception includes "isolated dispositions of section 306 stock by minority stockholders who do not in the aggregate have control of the distributing corporation" (S. Rept. p. 243), as well as dispositions of "section 306 stock" by stockholders who have previously disposed of, or simultaneously dispose of, the stock on which the "section 306 stock" was issued

Note that common stock distributed on common stock is not "section 306 stock." § 306(c)(1)(A). Why not? What *is* "common stock"? Why should common stock received by a shareholder who owns *preferred* stock be treated as "section 306 stock"?

* There is a conflict on this point between the statute. § 306(a)(1)(B), which permits recovery of basis (after the stock's ratable share of earnings and profits has been taxed as ordinary income), and the example in the Senate Report (p 242), which assumes that the entire excess is taxed as capital gain. Apparently the stock would have an allocated basis by virtue of § 307(a).

† The constructive ownership rules of § 318(a) are applicable.

2. For discussions of the pre-1954 law, which by virtue of § 306(h) remains applicable to dispositions and redemptions of stock received before the new Code took effect, see DeWind, "Preferred Stock Bail-Outs and the Income Tax," 62 *Harv. L. Rev.* 1126 (1949), Darrell, "Recent Developments in Nontaxable Reorganizations and Stock Dividends," 61 *Harv. L. Rev.* 958 (1948); Kanter, "The Present Tax Status of Stock Dividends," 31 *Taxes* 418 (1953).

3. The problem of the preferred stock "bail-out" is not new. Note the parenthetical phrase in § 115(g) of the 1939 Code, quoted in the footnote to the *Roberts* case, *supra*, p. 496 The prototype of § 115(g), enacted in 1921, was directed *exclusively* at the redemption of shares that had been issued as stock dividends. The parenthetical phrase, subjecting redemptions to the test of § 115(g) whether the stock was issued as a dividend or not, was enacted in 1926, among other reasons for its enactment was a realization that a corporation wishing to distribute cash at capital gains rates might redeem some of its originally issued stock on a pro rata basis, either getting along thereafter with a smaller stated capital or replacing the redeemed stock with a stock dividend at a subsequent time. For some time after 1926, however, the courts, influenced by § 115(g)'s original purpose, were reluctant to apply it to the redemption of shares that had not been issued as a stock dividend. In the course of time, however, the courts departed more and more frequently from this restrictive construction. Bittker and Redlich, "Corporate Liquidations and the Income Tax," 5 *Tax L. Rev.* 437, 466–468 (1950)

2. *Recapitalizations*

> ***Note.*** **Section 354(a)(1) of the 1954 Code, relating to the recognition of gain or loss on exchanges of stock or securities in corporate reorganizations, is identical with § 112(b)(3) of the 1939 Code.**
>
> **Section 354(a)(2) of the 1954 Code, imposing a limitation on the "general rule" of § 354(a)(1), has no counterpart in the 1939 Code.**
>
> **Section 368(a)(1)(E) of the 1954 Code, defining "reorganization" to include a "recapitalization," is identical with § 112(g)(1)(E) of the 1939 Code.**

While the tax status of stock dividends has varied from time to time, it has always been clear that a distribution of its own *debt* securities by a corporation with earnings and profits is a taxable dividend. But the status of debt securities issued by a corporation in the course of a corporate *recapitalization* has been less clear.

Before the 1954 Code was enacted, § 112(b)(3) of the 1939 Code provided, as does the "general rule" laid down in § 354(a)(1) of the 1954 Code, that no gain or loss was to be recognized if stock or securities of a corporation that was a party to a "reorganization" were exchanged for other stock or securities of the same corporation Section 112(g)(1)(E) of the 1939 Code, like § 368(a)(1)(E) of the 1954 Code, defined "reorganization" to include a "recapitalization." Suppose, then, that a corporation "recapitalized" by calling in its outstanding common stock and issuing in exchange other common stock (with a different par value or some other alteration of rights) plus bonds, debentures, or notes? Was the transaction a tax-free exchange of the old stock for the new stock and bonds or other securities? A taxable sale or exchange of the old stock? A dividend of the bonds or other securities? The case that follows considers this problem.

The effect of a statutory change in 1954 is taken up in the note that follows the case.

BAZLEY v. COMMISSIONER

U.S. Supreme Court, 1947, 331 U.S. 737

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

The proper construction of provisions of the Internal Revenue Code relating to corporate reorganizations is involved in both these cases. Their importance to the Treasury as well as to corporate enterprise led us to grant certiorari, 329 U.S 695, 67 S. Ct. 62; 329 U.S. 701, 67 S. Ct. 77. While there are differences in detail to which we shall refer, the two cases may be disposed of in one opinion.

In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,900 shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of a plan of reorganization," and as such no gain is recognized for income tax purposes. I.R.C. §§ 112(g)(1)(E) and 112(b)(3). The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under §§ 22(a) and 115(a) and (g). 4 T.C. 897. The Circuit Court of Appeals for the Third Circuit, sitting en banc, affirmed, two judges dissenting. 155 F.2d 237.

Unless a transaction is a reorganziation contemplated by § 112(g), any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under § 112(b) (3). While § 112(g) informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1921. Congress has never defined it and the Treasury Regulations shed only limited light. Treas Reg. 118, Sec. 39.112(g). One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into

§ 112(g), assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in § 112(g) must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by § 112(g). Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of § 112(g). It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie § 112(g) and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars, concerns itself. See *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S 462, 53 S. Ct. 257, 77 L. Ed. 428, *Gregory* v. *Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L Ed. 596, 97 A.L.R. 1355, *Le Tulle* v. *Scofield*, 308 U.S. 415, 60 S. Ct. 313, 84 L. Ed. 355.

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of § 112 is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all

practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization. The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissable [inadmissable?] attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See *Dobson* v. *Commissioner*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248.

What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.

The Commissioner, the Tax Court and the Circuit Court of Appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § 112. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under Sec. 112 (c) (1) and (2). * *Commissioner* v. *Estate of Bedford*, 325 U.S. 283, 65 S. Ct. 1157, 89 L. Ed. 1611.

In the *Adams* case, No. 209, the taxpayer owned all but a few of the 5914 shares of stock outstanding out of an authorized 6000, par value $100. By a plan of reorganization, the authorized capital was reduced by half, to $295,700, divided into 5914 shares of no par value but having a stated value of $50 per share. The 5914 old shares were cancelled and the corporation issued in exchange therefor 5914 shares of the new no-par common stock and 6 per cent 20 year debenture bonds in the principal amount of $295,700. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. The old capital account was debted in the sum of $591,400, a new no-par capital account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The corporation at this time had accumulated earnings available for distribution in a sum not less than $164,514.82, and this account was left unchanged.

* §§ 356(a) and (b) of the 1954 Code. [Ed.]

At the time of the exchange, the debentures had a value not less than $164,208.82.

The Commissioner determined an income tax deficiency by treating the debenture bonds as a distribution of the corporation's accumulated earnings. The Tax Court sustained the Commissioner's determination, 5 T.C. 351, and the Circuit Court of Appeals affirmed. 155 F 2d 246. The case is governed by our treatment of the *Bazley* case. The finding by the Tax Court that the reorganization had no purpose other than to achieve the distribution of the earnings. is unaffected by the bookkeeping detail of leaving the surplus account unaffected. See § 115(b), and *Commissioner* v *Wheeler*, 324 U S. 542, 546, 65 S Ct 799, 801, 89 L Ed 1166

Other claims raised have been considered but their rejection does not call for discussion

Judgments affirmed.

Mr Justice Douglas and Mr. Justice Burton dissent in both cases for the reasons stated in the joint dissent of Judges Maris and Goodrich in the court below *Bazley* v *Commissioner*, 3 Cir., 155 F 2d 237, 244.

Note

1. The "general rule of § 354(a)(1) of the 1954 Code, which is identical with § 112(b)(3) of the 1939 Code, is subject to the limitation of § 354(a)(2)—it is made inapplicable if the principal amount of any securities received on the exchange is greater than the principal amount of the securities (if any) surrendered. In the *Bazley* case the stockholders did not surrender any "securities" Suppose they had owned both bonds and stock, and had surrendered both classes in exchange for new stock and new bonds of the same principal amount but with a different interest rate, maturity, or priority. Would the "general rule" of § 354(a)(1) be applicable, or could a court find that the new bonds were (in the language of the *Bazley* case) "virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer"? Or that the exchange did not partake "of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability"?

Where, as in the *Bazley* case, no securities were surrendered, the effect of § 354(a)(2), in conjunction with § 356(d), is that the securities received on the exchange are "boot" Would the gain be taxed under § 356(a)(1) or under § 356(a)(2)? If the taxpayer's basis for the stock he gave up was equal to or greater than the value of the stock and securities he received in exchange, could the bonds be taxed as a dividend under the 1954 Code?

2. The Court says that Congress has determined that gain and loss shall not be recognized 'where a formal distribution, directly or through an exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets" Why is this not an apt description of the *Bazley* and *Adams* recapitalizations? Is it not more applicable to these exchanges than to an exchange in the course of a corporate merger or consolidation, both of which are included in the term 'reorganization" by § 368(a)(1)(A)?

3 The *Bedford* case, cited by the Court, involved these facts: Under a recapitalization, a shareholder exchanged 3,000 shares of cumulative preferred stock (par value $100) for 3,500 shares of cumulative preferred stock (par value $75), 1,500 shares of common stock (par value $1), and $45,240 in cash. The shareholder's gain (the difference between the adjusted basis of the shares given up and the value of the stock plus the cash received) was $139,740. The corporation's "earnings and profits" were sufficient to cover the entire cash distribution. It was admitted by the government that the transaction was a reorganization exchange, and it was admitted by the taxpayer that

the cash was "boot." The only issue was whether under what is now § 356(a)(1) and (2) the "boot" should be taxed as capital gain or as a dividend. The Court, admitting that the matter "is not wholly free from doubt," concluded that because the corporation had earnings and profits, the distribution of cash had "the effect of the distribution of a taxable dividend." Its conclusion should be compared with the way in which the courts have construed the phrase "essentially equivalent to the distribution of a taxable dividend" under § 115(g) of the 1939 Code, *supra*, pp. 495-504.

4. It has been seen previously that on original organization corporations often issue bonds or debentures to the incorporators, instead of only stock, so that the corporation can lay a basis for the deduction of interest under § 163. Moreover, the bonds can be retired at capital gains rates under § 1232, whereas the redemption of stock would open the Pandora's box of § 302. In addition, an accumulation of surplus by the corporation to pay off the indebtedness, unlike an accumulation for the purpose of redeeming stock, may be permissable under § 531, *infra*, p. 581. The *Bazley* case and § 354(a)(2) mean that a corporation which does not issue debt securities for these purposes to its stockholders at the time of organization will not be able to rectify its error later on.

Does the *Bazley* case also threaten the corporation which issues bonds or other evidences of indebtedness at the time of organization? Note the statement that the debentures "were virtually cash." Does this mean that they might be regarded as "boot" rather than "securities" if issued in a § 351 transaction?

SEIDE v. COMMISSIONER

Tax Court of the U.S., 1952
18 T.C. 502

RAUM, Judge: The New Jersey Publishing Company had three classes of stock outstanding in August 1942: 1,600 shares of voting common, 2,500 shares of non-voting common, 3,200 shares of non-voting 8 per cent cumulative preferred having a par value of $100. The shares of stock were held as follows:

Owner	Voting Common	Non-Voting Common	Preferred
Daisy Seide		850	1,300
Harold Seide	200	300	300
Joan Fagan Trust		200	400
Lois Fagan Trust		200	400
Frederick A. Seide	600	100	
Arthur L. Fagan	800	100	
Elizabeth M. Fagan		500	
Arthur L. Fagan Jr., Trust		250	
Elisabeth Fagan			160
Marilyn Fagan			160
Robert A. Fagan			160
Peter S. Fagan			160
Constance A. Fagan			160
Total	1,600	2,500	3,200

Pursuant to a plan of readjustment of its corporate structure, the Company issued a total of $320,000 face amount 8 per cent 20-year debentures in August 1942, and exchanged the debentures for all its preferred stock, each holder receiving a $1,000 debenture for 10 shares of preferred stock. The Company canceled the stock thus received and adjusted the capital on its books accordingly. In determining the deficiencies originally, the Commissioner apparently

took the position that the distribution of the debentures in redemption and cancelation of the preferred stock was essentially equivalent to the distribution of a taxable dividend, within the meaning of 115(g) of the Internal Revenue Code The Commissioner now makes that contention only as to the four petitioners who held common (either voting or non-voting), and argues that the other five realized capital gain upon receipt of the debentures and that they have not proved their basis in the preferred stock which they surrendered. We hold that the exchange of debentures for preferred stock was not essentially the equivalent of a taxable dividend and that the exchange was tax free pursuant to § 112(b)(3).

Section 112(b)(3) provides for the nonrecognition of gain or loss "if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation. . . ." And § 112(g)(1)(E) defines "reorganization" to include "a recapitalization." There was here in fact a readjustment of the Company's capital structure, and there was an exchange of preferred stock solely for debentures. The transaction literally falls within the foregoing statutory provisions (*cf. Wolf Envelope Co.*, 17 T.C. 471), and unless there are considerations which render these provisions inapplicable they are dispositive of the present controversy.

The situation here is wholly unlike that presented in *Bazley* v. *Commissioner*, 331 U.S. 737, where the form of reorganization was employed in an effort to achieve the distribution of a disguised dividend, and where it was held that the reorganization provisions were not intended to govern in such circumstances. The net effect of the transaction in the *Bazley* case was a pro rata distribution of debentures among stockholders in such manner as to render them the substantial equivalent of a cash dividend. No such circumstances are present here. The exchange of debentures for the preferred did not even remotely resemble a pro rata distribution of debentures among the holders of the two classes of common stock, considered either separately or together

Five holders of the preferred stock owned no common stock whatever. The holders of 87½ per cent of the voting common owned no preferred and thus received no debentures. Similarly, several holders of a substantial block of non-voting common owned no preferred and likewise received no debentures. And finally, those holders of common who also owned preferred received debentures in percentages entirely unrelated to their holdings of common. To be sure, it is not a *sine qua non* of a taxable dividend that the distribution be made pro rata among the stockholders. But the fact that an alleged distribution is highly disproportionate raises a serious question whether it is in truth a disguised dividend.

Moreover, the debentures here involved were not readily marketable by reason of the following considerations They were unsecured and had a remote maturity date, without likelihood of acceleration except in the event of dissolution or insolvency; there was the risk that they might be subordinated to the payment of other obligations; the Company had obsolete plant and equipment, and its business was in an unhealthy state, having sustained net losses in four of five preceding years and having fared poorly in relation to its competitors The petitioners have asked us to find that the debentures had no fair market value at all. This we have not done, but the factors outlined above do show that the debentures could not readily have been sold, notwithstanding the Company's

relatively strong balance sheet, and this fact is an additional element to be considered in determining whether the transaction was in fact a distribution of earnings rather than the reorganization which it purported to be. Taking all the facts into account we conclude that there was not here a distribution essentially equivalent to a taxable dividend. The *Bazley* case is not controlling, indeed it points in the other direction.

Nor are the reorganization provisions inapplicable by reason of the absence of a "business purpose." One of the reasons for the elimination of the preferred stock was to wipe out the accumulated "deficit" in unpaid dividends, and we have no reason to conclude on this record that such objective was not attained. This was a valid business or corporate purpose (*cf. Okonite Co.* v. *Commissioner* (C.A. 3), 155 F.2d 248, 250, certiorari denied 329 U.S. 764, *Thermoid Co.* v. *Commissioner* (C.A. 3), 155 F.2d 589, 590, *Morainville* v. *Commissioner* (C.A. 6), 135 F.2d 201; *Skenandoa Rayon Corp.* v. *Commissioner* (C.A. 2) 122 F.2d 268, certiorari denied, 314 U.S. 696; *H. Grady Manning Trust* 15 T.C. 930, 942), and the reorganization provisions, which otherwise literally cover this controversy, cannot therefor be rendered inapplicable.

Note

1. How would the foregoing reorganization be treated under the 1954 Code?

Note that the table in the Court's opinion might be recast in the following form

Owner	Voting Common	Non-Voting Common	Preferred
Seide Family	800	1250	1600
Fagan Family	800	1250	1600

In determining whether a recapitalization exchange "has the effect of the distribution of a dividend," § 356(a)(2), can the effect on persons related to or controlled by the taxpayer be taken into account? Note that the constructive ownership rules of § 318(a) come into force only when they "are expressly made applicable."

2. Does the last paragraph of the opinion mean that a "business purpose" must be served by the recapitalization, else the gain (or loss) will be recognized? Is there a difference between a "shareholder" business purpose and a "corporate" business purpose? The lower courts in the *Bazley* case had written extensively on the subject of business purpose; note that the Supreme Court approved their conclusions "whatever may have been their choice of phrasing." See Bittker, "What is 'Business Purpose' in Reorganization?" *8th Annual N.Y.U. Inst. on Fed. Taxation* 134 (1950).

3. See generally Tarleau, "Recapitalizations," *11th Annual N.Y.U. Inst. on Fed Taxation* 371 (1953)

Section I. Spin-Offs, Split-Offs, and Split-Ups

Note: **Section 355 of the 1954 Code, relating to divisive reorganizations, is derived, with substantial modifications, from §§ 112(b)(11) and 112(b)(3) of the 1939 Code.**

Section 356 of the 1954 Code, relating to the receipt of "boot," is derived, with modifications, from § 112(c) and (e) of the 1939 Code.

Section 368(a)(1)(D) of the 1954 Code, defining the term "reorganization," is similar to § 112(g)(1)(D).

Sections 368(b) and (c) of the 1954 Code, defining the terms "party to a reorganization" and "control" respectively, are similar to §§ 112(g)(2) and 112(h) of the 1939 Code.

See Regs. 118, Secs. 39.112(g)-1-5 and 112(b)(11)-1-2.

When the shareholders of a corporation no longer wish to entrust their eggs to one basket, * there are various ways of getting them into several baskets. One is a corporate distribution to the stockholders of some of the assets; this will constitute a "dividend" if the corporation has earnings and profits. If instead, the assets are distributed to the shareholders in exchange for some of the corporation's stock, the distribution may run afoul of § 302(d), *supra*, p. 504, at least if the distribution is on a pro rata basis.

Other methods of dividing up the corporate investment are the "spin-off," the "split-off," and the "split-up." In a spin-off, the existing corporation, *A*, transfers some of its assets to *B* Corp., newly organized for the purpose, in exchange for *B*'s stock, which *A* then distributes to its shareholders. In a split-off, *A* also transfers some of its assets to *B* for *B*'s stock, but *A* distributes the *B* stock in exchange for part of its own stock. In a split-off, *A* transfers part of its assets to *B* Corp. and the rest to *C* Corp. both newly organized for the purpose, and then completely liquidates, distributing the *B* and *C* stock in exchange for its own. The economic consequences to *A*'s stockholders of all three methods are practically identical. Until 1954, however, the tax consequences of these transactions were quite divergent.

The split-up, under the 1939 Code, was a tax-free reorganization. The transfer of *A*'s assets to *B* and *C* was a reorganization, as that term was defined by § 112(g)(1)(D) [see § 368(a)(1)(D) of the 1954 Code], and all three corporations were "parties to the reorganization" by virtue of § 112(g)(2) [see § 368 (b) of the 1954 Code]. Consequently *A* recognized neither gain nor loss on its exchanges of property for the stock or securities of *B* and *C* because of § 112(b)(4) [see § 361(a) of the 1954 Code]. And *A*'s stockholders recognized neither gain nor loss on their exchange of *A* stock for the stock or securities of *B* and *C* under § 112(b)(3) [see § 354(a) of the 1954 Code].

The spin-off, on the other hand, did not fit into the statutory sections just outlined. The transfer by *A* of a part of its assets to *B* constituted a "reorganization" under § 112(g)(1)(D), so the corporation would recognize no gain or loss under § 112(b)(4). But the distribution of the *B* stock to *A*'s stockholders created difficulty. This was because in a spin-off there is no *exchange* of stock by *A*'s stockholders, as was required by § 112(b)(3). Before 1934, as *Gregory* v. *Helvering*, *infra*, p. 546, indicates, no exchange was required, but the Revenue Act of 1934 amended the statute so as to require an exchange. Thus the spin-off became a taxable distribution (if the corporation had earnings and profits), and it retained this unhappy status until 1951. Section 112(b)(11) of the 1939 Code, added in 1951, allowed spin-offs to be accomplished tax-free, but only under certain restrictions. These restrictions were that both corporations must be intended to "continue the active conduct of a trade or business" after the spin-off and that the new

* Such a division of corporate assets may be desired for a variety of business and personal reasons. There may also be tax reasons for dividing up a corporate enterprise into two or more entities. See *supra*, pp. 368–379, for the obstacles that must be surmounted if the desired tax savings are to be achieved.

corporation must not be "used principally as a device for the distribution of earnings and profits." These requirements, in modified form, have been carried over by the 1954 Code, but they are now applicable to all divisive reorganizations.

During the period (1934-51) when the spin-off was a taxable dividend rather than a tax-free reorganization, the status of the split-off was rather uncertain. It could be fitted into the language of the 1939 Code, just as neatly as the split-up. But the Treasury's view was that the split-off was functionally equivalent to the spin-off (why?), and that the two should be treated identically for tax purposes. This contention was rejected by the Tax Court in 1952 (in a portion of the *Spangler* case, *infra*, p. 549, that is omitted because made academic by the 1954 Code) and the Treasury finally conceded the point, Rev. Rul. 289, 54-1 C.B.—, but for many years the split-off was in general avoided by tax practitioners.

The foregoing discussion indicates that until 1954, the split-up was the safest method of dividing up a corporate enterprise. But it entailed a destruction of the old corporate entity, which might cause a loss of credits, carry-overs, and other tax advantages, as well as the possible loss of franchises or favorable contracts, the confusion of customers, *etc.*

The 1954 Code seeks to treat all divisive reorganizations in the same way. Section 355 is the capstone of its structure, it is applicable both to distributions (spin-offs) and to exchanges (split-ups and split-offs). Moreover, the old corporation can distribute (a term that includes exchanges) the stock or securities of a controlled corporation that it already owns, whereas under the 1939 Code there could be no tax-free transfer except in a "reorganization," which required that the controlled corporation be created as part of the plan. The requirements of § 355 that are of particular interest are § 355(a)(1)(B) and § 355(b). What types of transactions are they intended to forestall, and why? Note that these requirements are not explicitly imposed upon other types of reorganizations by § 354. § 354(b) is intended to prevent divisive reorganizations from taking place under § 354 to avoid the more restrictive provisions of § 355.

We have been concerned in the foregoing discussion with the question of what types of transactions come within the letter of the statute. But this is an area in which literal compliance with the law has been only the first step; and many transactions have failed of their purpose because they did not have the right spirit. The cases that follow should be read not as ancient history, but for the light they shed on the practical problems with which § 355 is concerned and on the approach that the courts are likely to adopt in construing it. Does the statute now carry its own safeguards so that the courts will say that Congress could not have intended them to act as policemen any longer?

GREGORY v. HELVERING

Supreme Court of the U.S., 1935
293 U.S. 465

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities

Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under § 112(g) of the Revenue Act of 1928, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation, as capital net gain, the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax though the United Corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the Circuit Court of Appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F.(2d) 809. Petitioner applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ. 293 U.S. 538, 55 S. Ct. 82, 79 L. Ed. 645.

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> Sec. 112. . . . (g) *Distribution of Stock on Reorganization.* If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. . . .
>
> (i) *Definition of Reorganization.* As used in this section . . .
>
> (1) The term "reorganization" means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. . . .

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within

the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States* v. *Isham*, 17 Wall. 496, 506, 21 L. Ed. 728; *Superior Oil Co.* v. *Mississippi*, 280 U.S. 390, 395, 396, 50 S. Ct. 169, 74 L. Ed. 504; *Jones* v. *Helvering*, 63 App. D.C. 204, 71 F.(2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" (section 112(g)) of corporate business, and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose, it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

Note

1. This is one of the most famous cases in our field, and it has been almost all things to all men. Judge L. Hand, who had decided the case in the Court of Appeals, once wrote of the case

> In *Gregory* v. *Helvering* . . . , the incorporators adopted the usual form for creating business corporations, but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world. (*Chisolm* v. *Commissioner*, 79 F.2d 14, 15, 2d Cir. 1935).

Is this explanation consistent with the following later comment by Judge Hand?

The doctrine of *Gregory* v. *Helvering* . . . means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation. (*Commissioner* v. *Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949).)

2. The statutory provision making a spin-off tax-free was repealed by the Revenue Act of 1934, before the *Gregory* case was decided by the Supreme Court.* Thereafter, until § 112(b)(11) of the 1939 Code was enacted by the Revenue Act of 1951, *infra*, pp. 552-3, a spin-off was a taxable distribution.

SPANGLER v. COMMISSIONER

Tax Court of the U. S., 1952
18 T.C. 976

VAN FOSSAN, Judge. The only issue in this proceeding is whether the petitioners' exchange of 6 shares of Western States stock for 12 shares of Permian stock is taxable, and, if so, whether as capital gain or as ordinary income. The petitioners contend that the transaction was in pursuance of a plan of reorganization and that no gain or loss is to be recognized. Alternatively, they argue that the distribution was in partial liquidation. Respondent urges that the distribution of Permian stock to the shareholders of Western States was a taxable property dividend under section 115(a) of the Internal Revenue Code[1] and, also, that the transaction constituted a redemption of the stock accompanied by a distribution essentially equivalent to a taxable dividend within the meaning of section 115(g), I. R. C.[2]

The entire transaction consisted of two exchanges. Western States first exchanged its Texas properties and Government bonds for all of Permian's outstanding stock. Section 112(b)(4), I. R. C.,[3] is applicable to this transaction if the exchange was made by parties to and in pursuance of a plan of reorganiza-

* This action by Congress was partly the result of the fact that the Board of Tax Appeals in 1932 had decided the *Gregory* case in the taxpayer's favor, saying "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration" 27 B T A 223, 225.

[1] Sec. 115. Distributions By Corporations

(a) Definition of Dividend.—The term "dividend" . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . .

[2] Sec. 115. Distributions By Corporations.

(g) Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

[3] Sec. 112. Recognition Of Gain Or Loss.

(b) Exchanges Solely in Kind.—

(4) Same—Gain of corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization

tion. The subsequent exchange consisted of distributing the Permian stock to the shareholders of Western States for half of their stock in that corporation. Section 112(b)(3), I.R.C.,[4] is applicable here if the distribution of Permian stock for the Western States shares constituted an exchange and if the corporations were parties to and the exchange made in pursuance of a plan of reorganization.

Sections 112(b)(3) and 112(b)(4) both require that the exchanges be made in pursuance of a plan of reorganization and involve stocks, securities or property of a corporation a party to a reorganization. A reorganization is defined in section 112(g)(1)(D) as "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred. . . ." The present transaction meets this definition in that after the transfer of oil properties and bonds for Permian stock Western States controlled the new corporation by the ownership of all of its stock and within 4 months thereafter the shareholders of Western States owned all of the Permian stock. Since the exchange was made as part of the plan of reorganization and both Western States and Permian were parties to the reorganization the exchange falls within the terms of § 112(b)(4) if there are no other requirements. . . .

The respondent concedes that the exchange of oil properties for Permian stock maintained a continuity of interest but denies the existence of the required business purpose. *Gregory* v. *Helvering*, 293 U.S. 465; Regs. 118, sec. 39.112(g)-1. It is to be noted that the drilling of oil wells upon unproven leaseholds is a different and more speculative business than manufacturing casinghead gasoline on a contract basis. The division of a business carrying on more than one type of operation into independent entities, engaged separately in the same undertakings, has been recognized for tax purposes. *Buffalo Meter Co.*, 10 T.C. 83; *Miles-Conley Co.*, 10 T.C. 754, affirmed 173 F.2d 958. We are of the opinion that there were adequate financial as well as inherent industrial reasons for separating Western States' oil operations in Texas from the gasoline processing operations in California. Corporate surplus had declined since commencement of the Texas operations, and, although it remained over $1,000,000, dividends had declined until none were paid in 1942. Earnings from California operations were insufficient to cover the operating losses from the Texas properties in 1941 and 1942. The allowable production of oil and ability to ship oil were curtailed by the small pipeline outlet. The threat of necessarily making sizeable drilling expenditures if oil was struck by competitors on adjacent leaseholds existed at the same time that Western States was required to process, in wartime, all the gas offered by their contractual customers in California. The possibility of a new processing plant being built by others to offset the demand upon Western States' facilities was diminished because of the difficulties in procuring necessary materials in time of war.

[4] Sec. 112 Recognition Of Gain Or Loss.

(b) Exchanges Solely in Kind.—

(3) Stock for stock on reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

After Permian was formed, it increased its output and prospered. Had it been known in advance that it would prove so successful, the same financial reasons of avoiding a drain upon Western States' resources might not have existed. However, it could not be foreseen with accuracy if and when pipeline facilities could be obtained following the entry of the United States into the war in 1941. It was uneconomical to drain off California earnings to drill more oil wells at a time when the oil could not be shipped. Since Western States' accounting difficulties could have been overcome by providing local accounting for that corporation, we do not believe that accounting and managerial reasons necessitated the separation. Local management existed to some extent since the president of Western States lived at the site of the Texas operations. However, it is also true that if the Texas operations produced taxable income Western States would have to prorate its income for the California franchise tax.

Permian was financed with $400,000 in Government bonds and, if it was thought worth while to expand Permian's drilling operations, new capital might be required. Western States wished to avoid the necessity of guaranteeing loans sought by the new corporation as a subsidiary and, for this reason, the Permian stock was distributed to Western States' shareholders. As it turned out, Permian did not need to cash all the bonds for working capital. But this is known only with the benefit of hindsight.

Another business reason for the distribution of Permian stock to the shareholders of Western States is that this distribution avoided the subjection of dividends paid by Permian to the California franchise tax.

Upon all the facts, it appears that the reorganization of the two types of operations into separate corporate entities, possessed the necessary business purpose and was not ". . . merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders." *Bazley* v. *Commissioner*, 331 U.S. 737, 743. The separation continued the same two businesses under a changed form which was introduced for reasons ". . . germane to the conduct of the venture in hand." *Helvering* v. *Gregory*, 69 F.2d 809.

The respondent contends that because the shareholders of Western States maintained the same proportional interests in Western States before and after the pro rata redemption they gave up nothing in giving back half of their stock. Nothing, therefore, it is said, was received by Western States to constitute an exchange within the meaning of section 112(b)(3). We do not so construe the statute nor do we agree with respondent that the distribution was a dividend within the purview of section 115(a). The distribution of assets held by the corporation for half of its outstanding stock was much the same as a distribution in partial liquidation under sections 115(c) and 115(i), I. R. C.[5] The existence of earnings and profits does not preclude a partial liquidation. *Joseph W.*

[5] Sec. 115. Distributions by Corporations.

(c) Distributions in Liquidation—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. . . .

(i) Definition of Partial Liquidation—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Imler, 11 T.C. 836. The exchange of stock for the distribution is the difference between a taxable dividend and a partial liquidation in such an instance, but the pro rata exchange does not alter the shareholders' proportional interests. In so far as sections 115(c) and 115(i) are applied, the distribution here in question qualifies as a partial liquidation. As such, ". . . amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. . . ." Thus, section 115(c) limits recognition of gain or loss to the distributee of a partial liquidation to the extent provided in section 112. A partial liquidation in which no gain or loss is recognized because of section 112(b) would, of necessity, be the type of reorganization we have here. Similar pro rata distributions of stock and reduction of capitalization by the distributing corporation qualified as exchanges under section 112(b)(3). *Hortense A. Menefee,* 46 B.T.A. 865; *W. N. Fry,* 5 T.C. 1058.

Nor do we agree with respondent's argument that the distribution was essentially equivalent to a dividend under section 115(g). Although there is no established weighted formula to resolve this issue, *Flanagan* v. *Helvering,* 116 F.2d 937, the determinative criteria set forth in *Joseph W. Imler, supra,* do not bring us to that conclusion. There was a valid business purpose in separating the speculative Texas oil venture from the California operations. The motive in distributing the Permian stock was to keep control of the new corporation in the hands of the same stockholders. The surplus of Western States which had declined since 1938 remained over $1,000,000 after the reorganization. The past dividend policy had been liberal, and the significant special circumstances attending the distribution was the creation of a new entity for the oil business to be owned by the same interests. A dividend would not achieve this end. Section 115(g) being inapplicable, we conclude that the literal and substantive requirements of the statute have been met. . . .

Upon this basis we can but conclude that the petitioners received the stock in a reorganization in which there is no recognition of gain or loss. Petitioners' alternative argument need not be considered

Reviewed by the Court.

Decisions will be entered under Rule 50.

Note

1. How would this transaction fare under the 1954 Code? In 1944, the year after the *Spangler* reorganization, the stock of both Permian and Western States was sold to outsiders. According to the findings of the Tax Court, the sales were not pursuant to any prearranged plan. See § 355(a)(1)(B). Why is a prearranged sale forbidden? Would a prearranged sale by one stockholder deprive all stockholders of the benefits of § 355?

2. As mentioned earlier, § 355(a)(1)(B), relating to transactions used as devices to distribute earnings and profits, and § 355(a)(1)(C), requiring the active conduct of a trade or business, are derived from § 112(b)(11) of the 1939 Code, which reinstated the spin-off in 1951 with these restrictions. See Mette, "Spin-Off Reorganization and the Revenue Act of 1951," 8 *Tax L. Rev.* 337 (1953); Note, Tax Treatment of Corporate Divisions, 52 *Col. L. Rev.* 408 (1952); Wolff, "Divisive Reorganizations as Affected By the Revenue Act of 1951," 31 *Taxes* 716 (1953).

3. Under the old spin-off section, § 112(b)(11) of the 1939 Code, the distributing corporation could distribute only common stock of the new subsidiary. A distribution of preferred stock was expressly prohibited, presumably to prevent a spin-off of preferred stock as a method of bailing out earnings and profits. Section 355 of the 1954 Code has no restriction on the type of stock or securities to be distributed in a divisive reorganization (except that if the principal amount of the distributed securities exceeds the principal amount of any securities surrendered, the excess constitutes "boot" under § 356(d)), but the protective function of the old prohibition on preferred stock is now performed by § 306(c)(1)(B).

While § 112(b)(11) of the 1939 Code did not in terms require that all the stock of the new subsidiary be distributed, the regulations took the position that a retention of any stock would ordinarily cause the spin-off to be treated as a distribution of earnings rather than as a tax-free reorganization. Regs. 118, Sec. 39.112(b)(11)-2(c). Why? The new statute, it will be noted, requires a distribution of all the stock and securities of the controlled corporation, unless the Secretary of the Treasury is satisfied that the retention of stock or securities is not pursuant to a tax-avoidance plan, and even then, the distributing corporation may not retain control of the controlled corporation. § 355(a)(1)(D).

LEWIS v. COMMISSIONER

U.S. Court of Appeals, First Circuit, 1949
176 F.2d 646, cert. den. 346 U.S. 828

Before MAGRUDER, Chief Judge, and CLARK (by special assignment) and WOODBURY, Circuit Judges.

MAGRUDER, Chief Judge.

This case is before us for the second time on a petition to review a decision of the Tax Court, reported in 1948, 10 T.C. 1080. Petitioners have sought, by invoking the doctrine of *Gregory* v. *Helvering*, 1935, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A.L.R. 1355, to avoid the tax consequences of a transaction falling within the literal language of the statutory definition of a "reorganization." I.R.C. § 112(g)(1)(D). On the first petition, we vacated the Tax Court's decision, reported in 1946, 6 T.C. 455, and remanded the case for further proceedings. 1 Cir., 1947, 160 F.2d 839. The factual background has been clarified on the remand.

John B. Lewis died in 1930, and John D. Lewis, Inc., a Rhode Island corporation (hereinafter called the old company), was organized in 1931 to take over the business which the decedent had operated. The common stock was issued to the trustees under decedent's will, and had a basis of $435,000 in their hands. Petitioners are the surviving trustees.

The old company was engaged in three different lines of business in 1941: the manufacture of synthetic resins, the manufacture of chemicals for the textile industry, and the distribution of chemicals. In July, 1941, the synthetic resin business and the chemical distributing business were sold for a total of approximately $325,000 in cash and marketable securities. At that time petitioners, who were directors of the old company, tried to sell the chemical manufacturing business too, but their efforts were unsuccessful. They decided to continue operating this business until they could dispose of it at a fair price, but they did not want to leave the old company's liquid assets at the risk of the

chemical manufacturing business. Advice of counsel was sought as to how to distribute the liquid assets so as to incur a minimum tax. The decision was reached to transfer the operating assets of the chemical manufacturing business to a new corporation in exchange for its stock and to distribute this stock, together with the old company's liquid assets, in liquidation of the old company.

Steps were then taken to carry this decision into effect. On December 27, 1941, the directors of the old company voted to transfer to a corporation to be organized (hereinafter called the new company) all the assets of the old company, other than cash in excess of $90,000 and securities, in consideration of the issuance to the old company of the capital stock of the new company and the assumption by the latter of the old company's liabilities. This action of the directors was ratified by the shareholders on the same day. On December 29, 1941, the new company was incorporated under the laws of Rhode Island. At 11 A.M. on that day, the old company made the transfer of assets to the new company in exchange for its stock, and at 11:30 A.M. the directors of the old company voted to liquidate that company by distributing its remaining assets, including the stock of the new company, to the shareholders of the old company in cancellation of the old company's outstanding shares. Immediately thereafter the shareholders of the old company ratified this action, and it was carried out. The Tax Court found that the gain realized by petitioners, as trustees, on this exchange was $66,107.30, and this amount was not disputed by petitioners. The cash distributed to petitioners exceeded this sum, and the undistributed earnings or profits of the old company accumulated since 1931 also exceeded it.

The Tax Court found that "there was no interruption of [the chemical manufacturing] business and no change of location, policy, personnel, officers, or directors, but no salaries were paid to the officers. The new company continued to conduct the chemical manufacturing business until the latter part of 1944, when the Hercules Powder Co. purchased the bulk of its assets. The new company was liquidated and dissolved in 1945. The 1941 transfer of assets from the old company to the new company in exchange for the latter's stock was undertaken for reasons germane to the continuance of the corporate business. There was a business purpose in the transaction, and the plan which was adopted and carried out effected a genuine reorganization of corporate business, with a continuity of the enterprise and continuity of interests therein under a modified corporate structure."

On the fiduciary income tax return of the Estate of John B. Lewis for the year 1941, petitioners reported the gain on the exchange of the old company's shares as a long-term capital gain under I.R.C. §§ 115(c) and 117, realized upon the complete liquidation of the old company. The Commissioner determined a deficiency on the grounds that the liquidating distribution to petitioners by the old company was made pursuant to a plan of reorganization; that under § 112(c)(1) the gain was recognized in full since it was less than the value of the "boot," that is, the cash and securities (other than the stock of the new company) distributed, and that since the distribution had the effect of a dividend, it was taxable as such pursuant to § 112(c)(2).* On the basis of the above findings, the Tax Court sustained the Commissioner. This decision of the Tax Court is now before us on review.

* See § 356 of the 1954 Code, relating to the distribution of "boot." [Ed.]

Sometimes the taxpayer seeks to establish that a statutory reorganization did not take place. *E.g.*, *Survaunt* v. *Commissioner*, 8 Cir., 1947. 162 F.2d 753. Other times the Commissioner takes that position. *E.g.*, *Bazley* v. *Commissioner*, 1947, 331 U.S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782, 173 A.L.R. 905. Our determination of the substantive question must not be controlled by whether in the particular case it is to the advantage of the government or of the taxpayer to make out that no statutory reorganization has been effected. See *Lyon, Inc.*, v. *Commissioner*, 6 Cir., 1942, 127 F.2d 210, 213.

Rather, the effort should be to seek out the true intendment of the law, let the chips fall how they may in the particular litigation. Otherwise, to change the metaphor, interpretative chickens may come home to roost at a time when the barnyard wears quite a different aspect. (*Portland Oil Co.* v. *Commissioner*, 1 Cir., 1940, 109 F.2d 479, 488.)

In the present case, the integrated character of the steps in the plan pursuant to which the new company was created and the old company liquidated is not disputed. What took place is patently within a literal interpretation of the statutory definition of reorganization in § 112(g)(1)(D):

The term "reorganization" means . . . (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.

Not only do "the facts answer the dictionary definitions of each term used in the statutory definition," but we conclude that Congress meant to cover the situation in suit. As a leading practitioner has put it,

the essence of [a statutory reorganization] is a continuance of the proprietary interests in the continuing enterprise under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the stockholder gets something in addition to stock or securities in the reorganized company.

Darrell, "The Scope of Commissioner v. Bedford Estate," 24 *Taxes* 266, 272 (1946); see *Gross* v. *Commissioner*, 5 Cir., 1937, 88 F.2d 567, 568; *Commissioner* v. *Gilmore's Estate*, 3 Cir., 1942, 130 F.2d 791, 794; 3 Mertens, *Federal Income Taxation* § 20.50. This description fits the transaction here.

However, petitioners contend that *George D. Graham* v. *Com'r*, 1938, 37 B.T.A. 623, governs and supports their position that a statutory reorganization did not take place. Even assuming the correctness of the *Graham* decision for purposes of this case, we nevertheless consider it distinguishable. There the old corporation sold about 95 per cent of its assets, and then transferred the remaining 5 per cent, consisting of notes, mortgages, stock, *etc.*, to a new corporation in exchange for the latter's stock. The old corporation then liquidated, distributing cash and securities and the new corporation's stock to its shareholders in return for their stock. The Commissioner disallowed the loss taken on the exchange by some of the shareholders in the old corporation, but the Board of Tax Appeals upheld their contention that no reorganization had taken place. According to the Board, the new corporation "was organized to liquidate the remaining assets of [the old corporation] and not to carry on any business enterprise"; the statute "was not intended to include such a transaction." 37 B.T.A. at page 630. Hence, the loss on the liquidation exchange was held to be allowable.

Thus, in the *Graham* case, the Board apparently concluded that a *sine qua non* of a statutory reorganization was absent: "Reorganization presupposes *continuance of business* under modified corporate forms." *Cortland Specialty Co.* v *Commissioner*, 2 Cir., 1932, 60 F.2d 937, 940, (italics added). But in the present case, petitioners' plan contemplated that the new company *would* carry on the chemical manufacturing business transferred to it, and this was done. Although petitioners' intention was to dispose of the chemical manufacturing business eventually, the fact that a going business was transferred and operated left the new company and petitioners, its shareholders, in a position where they stood to gain or lose from operations just as before the transfer; if business conditions warranted it, the business could have been continued indefinitely.

The liquidation of the old company does not change matters because a statutory reorganization may encompass as one of its incidents the liquidation of one of the corporations a party to the reorganization. *Commissioner* v. *Whitaker*, 1 Cir., 1938, 101 F.2d 640, *Helvering* v. *Schoellkopf*, 2 Cir., 1938, 100 F.2d 415; *Fisher* v. *Commissioner*, 6 Cir., 1939, 108 F.2d 707, *Elise W. Hill's Estate* v. *Com'r*, 1948, 10 T.C. 1090. Nor does the statute make the amount of property transferred to the new corporation a decisive factor in determining whether a reorganization took place. *Helvering* v. *Schoellkopf*, *supra*. What is controlling is that in both the "popular and economic sense," [1] and the intendment of the statute, considerations of "boot" aside,[2] gain or loss is not sufficiently crystallized for recognition by the mere transfer of a going business to another corporation for operation indefinitely; "the collective interests still remained in solution." *Helvering* v. *Gregory*, 2 Cir., 1934, 69 F.2d 809, 811. Hence, the transaction was within the statute.

Somewhat the same disposition may be made of petitioners' further argument. They maintain that the creation of the new company and the transfer to it of the chemical manufacturing business was motivated by the desire to free the liquid assets of the old company from the risks of the manufacturing business; that the old company could have continued to operate the manufacturing business, and that only the shareholders received any advantage from the new arrangement. In short, their position is that no statutory reorganization took place because the plan was motivated by a "shareholder purpose" and not the "corporate purpose" which they say is required by *Gregory* v. *Helvering*, 1935, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed 596, 97 A.L.R. 1355. We reject this argument, as did the Tax Court.

At one time, in applying the so-called "business purpose" test of the *Gregory* case, the Tax Court did distinguish between "shareholder purpose" and "corporate purpose" in closely held corporations. *Louis Wellhouse, Jr.* v. *Com'r*, 1944, 3 T.C. 363; *Alice H. Bazley* v. *Com'r*, 1945, 4 T.C. 897; *Adam A. Adams* v *Com'r*, 1945, 5 T.C. 351; *Marion Heady* v. *Com'r*, 1945, 4 CCH TCM Dec. 14,702(m). We think that the Tax Court has been correctly advised in unequivocally repudiating that distinction here. *Cf. Richard H. Survaunt* v. *Com'r*, 1945, 5 T.C. 665, affirmed 8 Cir., 1947, 162 F.2d 753; see Comment, 43 *Ill. L. Rev.*

[1] Commissioner v. Capento Securities Corp, 1 Cir., 1944, 140 F.2d 382, 385.

[2] We must decide whether there was a reorganization irrespective of the presence of "boot" in the old company's liquidating distribution. Section 112(c) sets forth the tax consequences because of the "boot." Commissioner v. Estate of Bedford, 1945, 325 U.S. 283, 65 S. Ct. 1157, 89 L. Ed. 1611. See *infra*.

512, 517 (1948). To seek to differentiate between "corporate purpose" and "shareholder purpose" in unrealistic and impractical, particularly with respect to closely held corporations. See Spear, " 'Corporate Business Purpose' in Reorganization," 3 *Tax. L. Rev.* 225, 242–43 (1948). The separate legal identity of these corporations should not obscure the fact that they are operated by their shareholders in a manner thought best calculated to serve the latter's interests. What is deemed best for the shareholders is deemed best for the corporation, and vice versa. We think it not insignificant that, in affirming the *Bazley* and *Adams* decisions, the Supreme Court gave no countenance to the distinction petitioners advocate. 1947, 331 U S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782, 173 A.L.R. 905.

Whatever hesitation we may have had earlier, we are now convinced that emphasis upon "business purpose" as a requisite for statutory reorganization is futile on the facts here presented.[3] *Cf.* Lourie, "The Business Purpose Doctrine," 25 *Taxes* 800, 805-06 (1947). This is not a situation as in the *Gregory* case where the new corporation was an evanescent creature, "brought into existence for no other purpose" than to serve as

> a mere device . . . to transfer a parcel of corporate shares to a shareholder, and immediately thereafter dissolved. There it was clear that the transaction upon its face lies outside the plain intent of the statute. (293 U.S at pages 469 470, 55 S. Ct. at page 268, 79 L. Ed. 596, 97 A.L.R. 1355.)

Here we regard it as equally clear that the transaction lies *inside* "the plain intent of the statute."

As we have stated, continuance of the business is a *sine qua non* of a statutory reorganization, but we need look no further than the *Bazley* case to see that in some contexts the mere fact that the business is continued does not mean that a statutory reorganization has taken place. See Spear, " 'Corporate Business Purpose' in Reorganization," 3 *Tax L. Rev.* 225 (1948). Hence, to denominate as "business purpose" the intention to have the new company continue the chemical manufacturing business would serve only to confuse Whatever remaining utility there may be in the "business purpose" test, reliance upon such formula must not become a substitute for independent analysis. The controlling factor which we have concluded brings this case within the statute is that a basic element of the plan was the continuance of the chemical manufacturing business in the corporate shell of the new company, with the gain (were it not for the "boot") not having sufficiently crystallized for recognition, because the collective interests of the shareholders "still remained in solution." See *Love* v. *Commissioner*, 3 Cir., 1940, 113 F.2d 236; *Heatley Green* v. *Com'r*, 1942, 1 CCH TCM Dec. 12,922-E; 34 *Va. L. Rev.* 842 (1948).

If the shareholders of the old company had received only stock in the new company in cancellation of their old shares, under § 112(b)(3) of the Code no gain would have been recognized. Because of the "boot" also distributed, § 112 (c)(1) provides that the gain is recognized here. Once it is decided against petitioners that a reorganization took place, petitioners have not argued in the alternative, either here or in the Tax Court, that the gain should nevertheless,

[3] We do not pause to consider whether the vitality of the "business purpose" test has been undermined by the Bazley case. Compare Heady v. Commissioner, 7 Cir., 1947, 162 F 2d 699, Survaunt v. Commissioner, 8 Cir., 1947, 162 F.2d 753, with Ballantine, Psychological Bases for Tax Liability, 27 Harv Bus Rev 200, 207 (1949).

under § 112(c)(2), be treated as a gain from the exchange of property (long-term capital gain), and not as a dividend. Compare *Commissioner* v. *Estate of Bedford*, 1945, 325 U.S. 283, 292, 65 S. Ct. 1157, 89 L. Ed. 1611, *Love* v. *Commissioner*, *supra; Hill's Estate* v. *Com'r*, *supra; Heatley Green* v. *Com'r*, *supra;* Hoffman, "Impact of the Bedford Case on Reorganizations," in *N.Y.U. Sixth Annual Inst. on Federal Taxation* 279 (1948), with Darrell, "The Scope of Commissioner v. Bedford Estate," 24 *Taxes* 266, 272-73 (1946). We have not considered this possible alternative treatment of the transaction. See 9 Mertens, *Federal Income Taxation* § 51.31 (1943); *Hormel* v. *Helvering*, 1941, 312 U.S. 552, 61 S. Ct. 719, 85 L. Ed. 1037.

The decision of the Tax Court is affirmed.

Note

1. Under the 1954 Code, could the liquid assets or the chemical manufacturing business be "spun-off" without the recognition of gain by a transfer to a new corporation and a distribution of its stock to the shareholders of the old corporation? What if the liquid assets had been transferred to one new corporation and the chemical business to another, followed by a complete liquidation of the old corporation?

Would a distribution of the liquid assets or of the chemical business by the old corporation constitute a "partial liquidation" under § 331(a)(2) of the 1954 Code?

2. On the final paragraph of the *Lewis* case, see the *Bedford* case, *supra*, p 541, and Wittenstein, "Boot Distributions and Section 112(c)(2); A Re-examination," 8 *Tax L.* Rev. 63 (1952); Darrell, "The Scope of Commissioner v. Bedford Estate," 24 *Taxes* 266 (1946).

3. Before 1954, there was great uncertainty about the tax consequences of a divisive reorganization in which one stockholder or group of stockholders received one parcel of assets while another received a different parcel. See Lyons, "Realignment of Stockholders' Interests in Reorganizations Under Section 112(g)(1)(D)," 9 *Tax L. Rev.* 237 (1954).

See § 355(a)(2)(A) of the 1954 Code.

4. Earnings and profits are not reduced by a non-taxable spin-off, split-off, or split-up. § 312(d). An appropriate portion of the earnings and profits, however, follows the transferred assets into the new corporation. See § 312(i) of the 1954 Code, and *Mandel* v. *Commissioner*, 5 T.C. 684 (1945), apparently approved in *Commissioner* v. *Phipps*, 336 U.S. 410, 417, n. 10 (1949). An unused operating loss, however, is probably retained by the old corporation, it will be lost altogether if the old corporation is liquidated, as in the case of a split-up. Ohl, "Basis and Allocation of Earnings and Profits in Spin-Off, Split-Off and Split-Up Reorganizations," *11th Annual N.Y.U. Inst. on Fed. Taxation* 311, 337-42 (1953).

UNITED STATES v. ARCADE CO.

U. S. Court of Appeals, Sixth Circuit, 1953

203 F.2d 230

Before SIMONS, Chief Judge, and MARTIN and MCALLISTER, Circuit Judges.

MCALLISTER, Circuit Judge.

The issue in this case is whether certain business transactions amounted to a corporate reorganization under § 112(g) of the Internal Revenue Code, Title 26 U.S.C.A. § 112(g). The district court held that there was no reorganization, and the government appealed.

The facts are as follows: The Arcade Company, organized in 1902, long prior to the enactment of the Federal Income Tax Amendment, employed, in 1943, a tax accountant and attorneys to work out a plan to minimize federal taxes and provide for a larger share of the company's earnings for its stockholders. As a result, on September 22, 1943, the stockholders of the company, by resolution, voted to surrender its charter and dissolve the corporation on September 30, 1943; and the corporation was, accordingly, dissolved. The resolution further provided for two trustees in whom the assets of the dissolved corporation should be vested for disposition to the stockholders, or in such manner as they should direct. The former stockholders gave directions in writing to the trustees that the assets be transferred to a new corporation, to be thereafter organized, in return for its newly issued stock. Subsequently, the assets were transferred to a new corporation, Arcade Company, Inc., by the trustees, and in payment for the assets, the new company, delivered to the trustees for the stockholders shares of its stock for the assets of the old company. Thereafter, the trustees transferred the shares of stock to the beneficiaries of the trusts for which they were acting—the persons who had been stockholders in the old company—in the same proportion as in the old company.

The tax incident that gives rise to this controversy relates to the claim of a deduction for ordinary business expense. The Arcade Company claimed that the expense of the tax accountant and attorneys whom it employed to work out the plan to provide a larger share of the company's earnings for its stockholders was an ordinary and necessary expense in carrying out its business. The Commissioner determined that such expense was a capital expenditure rather than a current expense, and that it was not deductible. The district court, however, determined that it was deductible as a necessary business expense.

In contending that the transaction in question constituted a reorganization, the government relies upon the definition of a reorganization as set forth in I.R.C. § 112(g)(1). Appellee contends that there was no continuity between the old corporation and the new corporation, and that, under the relevant provisions of the statute, there was no reorganization; that the costs and expenses of counsel and auditors in preparing the plan were necessary business expenses of the old corporation, and, therefore, properly deductible, and that the judgment of the district court should be affirmed. . . .

The government claims that the transactions above set forth constituted a reorganization, as defined in § 112(g), and that the taxpayer corporation was liable for the deficiency assessment theretofore made, with interest. This contention is based upon the claim that the dissolution of the old corporation, the transfer of its assets to trustees for the stockholders, the organization of a new corporation, the direction by the former stockholders to the trustees to exchange the assets of the old corporation to the new corporation in consideration of the delivery of stock in the new corporation, was an integrated plan of reorganization, not to discontinue the business of the old corporation, but, rather, to continue the same business more profitably under a new guise. It is to be observed, however, that the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, by means which the law permits, can not be doubted. *Gregory* v. *Helvering,* 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596.

In the light of the above mentioned sections of the Internal Revenue Code, we compare what was actually done in this case, with these various statutory provisions.

In the first place, the charter of the old company was surrendered and the corporation was dissolved before the new corporation received the assets through transfer by the trustees. Manifestly, there could be no transfer by the old corporation of its assets to the new corporation which, in the strict language of the statute, is required in order to constitute a reorganization. Nor was there an exchange of property by the old corporation to the new corporation for the latter's stock, nor were there any agreements between the old and new corporations, or exchanges between them, pursuant to a plan of reorganization, all of which are necessary to reorganizations under § 112(g)(1). When the old corporation was dissolved, it was at an end and liquidated. Its assets were transferred to its former stockholders, or what was the same thing, to trustees for their benefit. The former stockholders paid income tax in the way of a capital gains tax on what they had received from their stock as a liquidating dividend. There was no right on the part of the dissolved corporation to enforce any agreement as to what was to take place subsequent to its dissolution. It had no rights or obligations, as far as any plan to form a new corporation was concerned, or to see that the trustees for the former stockholders entered into such a plan or transferred the assets to a new corporation. The former stockholders at the time of the liquidation of the old corporation were the absolute owners of the corporate assets. They were under no contractual obligations to form a new corporation or to transfer their assets to a new corporation in return for stock therein. They could have sold the assets to an outside real estate corporation or an individual, and in such a case, there could have been no claim that any reorganization had resulted from the transactions. The former stockholders of the old corporation had not bound themselves to carry out any plan of reorganization. The new corporation had no rights that could be enforced against the former stockholders of the old corporation to require them to form a new corporation, or, for that matter, any rights whatever with respect to the old corporation or the former stockholders thereof. Apparently the government contends that because the old corporation employed a tax accountant and lawyers to work out a plan whereby stockholders could secure a larger share of the company's earnings, and that, subsequently, the corporation followed the advice given, and the stockholders later acted upon it, there was a "plan of reorganization" within the intendment of the statute, and that the transactions above mentioned amounted to a reorganization pursuant to a plan therefor. But the "plan of reorganization," specified by the statute, is not just any suggestion or advice received from a lawyer or a tax accountant, even though it be acted upon by either a corporation, or its stockholders, or both. What is envisaged by a "plan of reorganization" within the intendment of the statute may be perceived in one of the provisions of the Treasury Regulations promulgated to carry out § 112 of the Internal Revenue Code, under the heading of "Records to be Kept and Information to be Filed With Returns." "The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation." Treasury Reg. 118, Section 39.112(g)-6.

When the old corporation was dissolved and the assets were transferred to its former stockholders, there was a break in the continuity of ownership, for, as a general rule, a corporation and its stockholders are deemed separate entities; and this is true in respect to tax problems. *New Colonial Ice Co., Inc.* v. *Helvering*, 292 U.S. 435, 54 S. Ct. 788, 78 L. Ed. 1348. The dissolution of the old company and the transfer of its assets to its former stockholders put a period to its existence. The new company was a different and separate enterprise. It is notable that throughout the regulations governing reorganizations under § 112(g), it is set forth variously that the terms, "reorganization" and "party to a reorganization," mean only a reorganization or a party to a reorganization as defined in § 112(g); that, in order to exclude transactions not intended to be included, the *specifications* of the reorganization provisions of the law are *precise*, and that both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception to the general rule; that the application of the term, "reorganization," is to be *strictly* limited to the *specific* transaction set forth in § 112(g)(1); that the term, "a party to a reorganization," includes, in addition to a corporation which performs the *specific* act constituting the reorganization, as described and defined in § 112(g)(1), only a corporation specified in § 112(g)(2); that the term, "plan of reorganization," has reference to a consummated transaction *specifically* defined as a reorganization under § 112(g)(1), and that the term is not to be construed as broadening the definition of reorganization as set forth in that section; and, as heretofore mentioned, that the plan of reorganization must be adopted by each of the corporations parties thereto. Regs. 118, Sec. 39 112(g)–1 to (g)–6, inclusive. We do not find, in what is here claimed by the government to constitute a "plan of reorganization," and a "reorganization," any such transactions, so precisely specified, so strictly limited to the language of the statute, and providing for such express adoption by the corporations, as are required by the regulations governing reorganizations under the taxing statute. We are of the opinion that the transactions in question did not constitute a reorganization under the Internal Revenue Code.

In *Braicks* v. *Henricksen*, D.C. Wash., 43 F. Supp. 254, where the taxpayer was concerned with seeking allowance of a dividends paid credit on an undistributed profits tax, the court was confronted with a problem almost identical to the one before us. It appeared in that case that in 1937, the directors of a corporation, called the Old Company, "concluded that the stated value of its capital stock was too low and that the corporation was paying excess profits taxes in an amount larger than the company's situation required. For the sole purpose of attempting to correct the situation and on the advice of the corporation's tax counsel, the following plan was devised and effectuated: (1) Proceedings were instituted for the liquidation of the Old Company. (2) All of the assets of the Old Company were transferred to plaintiffs as trustees for the stockholders and as liquidating trustees of the company by the declaration of a liquidating dividend. (3) The stockholders of the Old Company were advised by the company that the receipt on their behalf by the trustees of their proportionate share in the assets of the Old Company constituted a dividend subject to tax and every stockholder was advised as to the increase in his income tax resulting from the receipt of such

dividend. (4) With one exception, each of the stockholders paid such income tax in accordance with such advice. (The exception was an isolated one and his failure to pay had no connection with the corporation or the plan.) (5) Contemporaneous with these transactions, [the New Company] was formed. (6) Each stockholder of the Old Company was notified that he was free to choose as to whether or not to enter into the New Company and financial arrangements were made to make possible the purchase for cash from each stockholder of his proportionate share of the assets held for him by the plaintiffs as trustees. (7) Each stockholder subscribed for the stock of the New Company, the stock subscription obligation being payable in cash. (8) The subscribers to the capital stock of the New Company thereupon offered to the New Company that they would cause to be transferred to the New Company all of the assets held for them by the trustees subject to the obligations of the Old Company which the New Company was to agree to pay in fulfillment of their capital stock subscriptions of the New Company. (9) The New Company accepted the offer and stock was issued to the individuals in the same proportionate share as they owned stock in in the Old Company. (10) The assets were shown on the books of the New Company as of their net value as shown on the books of the Old Company. (11) The dissolution of the Old Company was completed." On the foregoing facts, the district court held that the transaction was not a "reorganization" but was a "liquidation," and that the liquidating trustees, in making income tax returns for the year in which the transaction occurred, were entitled to a dividend paid credit on such portion of the amount distributed in liquidation which was properly chargeable to earnings or profits of the old Company accumulated after February 28, 1913. On review, 9 Cir., 137 F.2d 632, the judgment of the district court was affirmed, the court of appeals saying that the pivotal point in the case was whether or not there was a real and bona fide distribution in liquidation made to the stockholders in the old company, and if there was such an actual distribution—however brief the interval during which each individual stockholder retained title to his share of the assets—then the taxpaying corporation was entitled to a dividends paid credit on the ground that the transaction was a liquidation rather than a reorganization. The court held that the evidence disclosed that there was an actual distribution to each stockholder, who thereafter could exercise an independent choice as to whether he would or would not go into the new company.

In its attempts to distinguish the *Braicks* case, *supra*, the government submits that the court therein did not find that the old company had adopted a plan of reorganization, but that it did find that the stockholders were advised that they were free to retain and dispose of their interest in the assets of the old company and to choose whether or not they would enter into the new company; and it is implied that this advice that the stockholders were free to act in the matter differentiated that controversy from the one before us. But in the instant case, there was no plan of reorganization adopted by the old company; and each stockholder, prior to the dissolution of the old corporation, received notice of the special meeting to consider acting upon arrangements to distribute the property of the company pro rata among the shareholders or to convey the property to a trustee for their benefit. After the meeting, the former stockholders were notified in writing

that provision had been made for the transfer of the assets to the trustees, and a suggested letter was submitted that stockholders could direct to the trustees. This proposed letter set forth how much stock had been owned by the stockholder, and directed the trustees to ascertain when and if a new corporation had been organized to do business similar to that of the old company. The proposed letter further authorized the trustees to transfer all of the assets of the old corporation to such a new corporation under certain conditions. It can hardly be concluded that the stockholders did not have the right, after the assets of the old company had been transferred to them or their trustees, to exercise, each for himself, an independent choice as to whether or not he would, or would not go into the new corporation. No one else could exercise the right for him, or require him to do so. We are of the opinion that the distinction which the government seeks to draw between the two cases is without substance, and we are persuaded by the reasoning of the court in the *Braicks* case.

Many authorities are cited by appellant in support of its contentions, and, in relying upon them, the government emphasizes that where transactions result in a new corporation which emerges and actually uses the transferred assets to continue the business with the same proprietary interests, such transactions amount to a reorganization. But the cases cited, are not here in point, and circumstances disclosed, as above mentioned, are not in themselves controlling. See *Glenn* v. *Courier-Journal Job Printing Co.*, 6 Cir., 127 F.2d 820. Here, there was a liquidation of the old company, and, as said by Judge Simons in *Mascot Stove Co.* v. *Commissioner*, 6 Cir., 120 F.2d 153, "liquidation is the antithesis of reorganization."

It is our conclusion that there was no transfer by the old corporation of its assets to the new corporation, within the meaning of § 112(g)(1); that neither the old nor the new corporation was a "party to a reorganization," as set forth in § 112(g)(2); and that the transactions out of which this controversy arose did not constitute a reorganization within the intendment of the Internal Revenue Code.

Having held against appellant upon the question of reorganization, and having concluded that the transactions in question amounted to liquidation of the old corporation, we are of the opinion that the services of the tax accountant and attorneys, here in question, were rendered to the old corporation; that the expenses incurred therefor were for the benefit of the old corporation; and, since they constituted ordinary and necessary expense in carrying on its business, they were properly deductible. To the same effect, see *Braicks* v. *Henricksen*, D.C., 43 F. Supp. 254, 261.

In accordance with the foregoing, the judgment of the district court is *affirmed.*

Note

1. In the *Arcade Co.* case, the liquidation produced gain to the shareholders. Presumably the result would have been the same if the stockholders had taken a loss on the liquidation.

If the reincorporation is treated separately from the liquidation, the earnings and profits of the old corporation do not carry over to the new corporation. *Mathis* v. *Commissioner*, 19 T.C. 1153 (1953). On a reorganization, however, the earnings and profits are preserved intact in the hands of the successor corporation. This means that even if

a liquidation will produce a gain, the stockholders might decide to liquidate in order to wipe out the corporation's earnings and profits account without the recognition of ordinary income. Moreover, the liquidation confers a new basis on both the stock and the corporate assets, while in a reorganization the old basis is carried over for both.

Where the stockholders will have a loss on a liquidation (or are willing to pay a capital gains tax on any gain they may have), can the restrictions of § 355 on spin-offs, split-offs, and split-ups be avoided by completely liquidating and transferring the assets, at a later date, to two or more new corporations?

2. The Conference Report states (p 41):

> The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.

See Johnson, "Dividing an Operating Corporation into Separate Entities," 1951 *So. Calif. Tax Inst.* 177, 186-190.

Section J. Combining Two or More Enterprises: Mergers, Consolidations, and the Like

> *Note:* Section 354(a)(1) of the 1954 Code, providing for the non-recognition of gain or loss on reorganization exchanges, is identical with § 112(b)(3) of the 1939 Code.
>
> Section 354(a)(2) of the 1954 Code, limiting the general rule of § 354(a)(1) in certain cases, has no counterpart in the 1939 Code.
>
> Section 354(b) of the 1954 Code, making § 354(a)(1) inapplicable to divisive reorganizations, is new and is associated with § 355.
>
> Section 356 of the 1954 Code, relating to the receipt of "boot," is derived, with modifications, from § 112(c) of the 1939 Code.
>
> Section 368(a) of the 1954 Code, defining the term "reorganization," is derived, with modifications, from § 112(g)(1) of the 1939 Code.
>
> Sections 368(b) and (c) of the 1954 Code, defining the terms "party to a reorganization" and "control" respectively, are similar to §§ 112(g)(2) and 112(h) of the 1939 Code.
>
> See Regs. 118, Secs. 39.112(g)-1-5.

In the preceding sections of this chapter, we have been concerned primarily with readjustments of a single corporate enterprise. Section 351 permits the tax-free incorporation of an enterprise. It also authorizes the tax-free creation of a subsidiary, overlapping in this respect §§ 368(a)(1)(D) and 361(a). Section 331 deals with the complete or partial liquidation of a corporation; § 332 with the complete liquidation of a subsidiary. Recapitalizations of a corporation involve §§ 305 and 354. The material on spin-offs, split-offs, and split-ups was concerned with the division of an existing enterprise into several entities.

We now turn to the problem of combining two or more enterprises. Suppose

for example, that *A* Corp., a local department store, is to be sold to *B* Corp., a national chain. The *A* shareholders may simply sell their stock to *B* Corp. for cash or they may cause *A* to sell its assets to *B* for cash. The tax effects of either type of sale are not difficult to work out. Suppose, however, that the consideration is to be paid partly or entirely in stock or securities of *B* or of some related corporation. Then the following routes, among others, are open:

(a) *A* can be merged into *B*, stock or securities in *B* being issued to *A's* stockholders in exchange for their *A* stock. A variation on this plan would be a consolidation of *A* and *B*, stock or securities in the consolidated corporation being issued to the stockholders of both *A* and *B*. Either transaction is a "reorganization" by virtue of § 368(a)(1)(A), and the exchange of stock by the stockholders is tax-free under § 354.

(b) *A* can transfer its assets to *B* in exchange for *B*'s voting stock. This is a reorganization under § 368(a)(1)(C), and *A's* exchange of its assets for *B* stock is tax-free under § 361(a). *A* can be kept alive, as a holding company, or it can be liquidated as part of the reorganization. Such a liquidation would be a tax-free exchange under § 354, since *A's* stockholders would exchange their *A* stock for the *B* stock.

(c) *A's* stockholders can transfer their stock to *B* in exchange for voting stock of *B*, *A* becoming a subsidiary of *B*. This is a reorganization under § 368(a)(1)(B), and the stockholders' exchange is tax-free under § 354. If desired, *A* could be liquidated by *B* under § 332.

(d) *A* and *B* could both transfer their assets to a newly organized corporation, C, in exchange for C stock. These transfers would be tax-free under § 351. Both *A* and *B* would then be holding companies

(e) The stockholders of *A* and *B* could all transfer their *A* and *B* stock to a newly organized corporation, C, in exchange for *C* stock. These transfers would qualify under § 351. *C* would then be a holding company.

The illustration above involves the combination of two previously unrelated business into a single corporate entity or hierarchy, but combinations of previously related entities are also common. Indeed, we have already encountered an example of such a transaction: the liquidation of a subsidiary under § 332. But the more elaborate methods of effecting a combination described above could also be adapted for use in combining two or more enterprises that were already affiliated in one way or another.

Section 381 prescribes rules for the carry-over of earnings and profits, net operating and capital losses, accounting methods, *etc.* by a corporation that has acquired the assets of another. The carry-over of net operating losses is subject to the restrictions of § 382. Before 1954, there was much uncertainty as to these items; not all were treated alike, and there were distinctions, often difficult to justify in policy, between corporations that were the result of mergers and consolidations and those that were the result of a transfer of assets. See Schorr, "Carry-Over and Carry-Back of Operating and Capital Loss in Consolidations and Mergers," *10th Annual N.Y.U. Inst. on Fed. Taxation* 1251 (1952); Note, Corporate Reorganization and Continuity of Earning History: Some Tax Aspects, 65 *Harv. L. Rev.* 648 (1952).

CORTLAND SPECIALTY CO. v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1932
60 F.2d 937

[The taxpayer, engaged in the business of buying and selling petroleum products, entered into an agreement with the Deyo Oil Company, whereby it was to transfer 91½ per cent of its net assets to Deyo (retaining the balance of its assets to take care of liabilities) and go out of business. The taxpayer's sole stockholder was thereupon to become Deyo's general manager in the territory previously served by the taxpayer. Deyo was to pay about $77,000 in cash and about $160,000 in promissory notes (with serial maturities of which the longest was fourteen months) for the transferred assets.]

Before L. Hand, Augustus N. Hand, and Chase, Circuit Judges.

Augustus N. Hand, Circuit Judge.

The question raised by this appeal is whether the transfer by Cortland Specialty Company to Deyo Oil Company, Inc., hereinafter described was a reorganization within the meaning of § 203 (h) (1) of the Revenue Act of 1926, which relieved the Cortland Company from paying an income tax upon any gain that might result therefrom, or whether the transfer was a mere sale which subjected the transferor to a tax on any profit which is realized. . . .

It may be said at the outset that the contract of Cortland with Deyo and the corporate resolution authorizing it to be made treat the transfer to the latter as a sale. The instrument begins by reciting that Cortland "has determined . . . to sell and dispose of all its physical and tangible assets," and that Deyo "has determined to purchase said assets." It goes on to say that Cortland "agrees to sell, transfer and convey . . . all and singular its real property, interests in real property, leases of real property . . . and equipment . . ." and later to say that it "shall sell . . . all of the merchantable gasoline, kerosene, oils and other petroleum products," and that Deyo "agrees to pay" the "purchase price of $213,000.00" for the "real property . . . and equipment" and a further "purchase price" to be determined by "an inventory taken at prevailing cost prices" for the "petroleum products." Nothing is said about the acquisition of any vested interest by Cortland or its stockholders in the business or assets of Deyo, but, on the contrary, it is provided that their interest shall be completely severed for, under article fifth of the contract, Cortland is "not to engage in the business of buying, selling or dealing in gasoline, kerosene or other petroleum products from and after October 1st, 1925," and is to receive nothing but cash and short time promissory notes as the consideration for the business and property sold. The transaction certainly bore all the characteristics of a simple sale.

But it is argued that under subdivisions (e) and (e) (1) of § 203 of the Revenue Act of 1926, "no gain or loss shall be recognized if a corporation a party to a reorganization" distributes "stock or securities" and "money" "in pursuance of the plan of reorganization," and that under subdivision (h) (1) (A) of the section of the act, the term "reorganization" is defined broadly enough to exempt Cortland from a profit tax on its transfer. In subdivision (h) (1) (A) a reorganization is defined as "*a merger or consolidation*," and the subdivision goes on to say that

"merger or consolidation" *include* "the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation." If the last clause means that any transfer of "substantially all the properties" of one corporation to another corporation is a reorganization, the position of Cortland is strong; but we do not regard such an interpretation as warranted.

Reorganization, merger, and consolidation are words indicating corporate re-adjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more, Reorganization in the most ordinary sense suggests "the formation of a new corporation [by the creditors and shareholders of a corporation] that is in financial difficulties, for the purpose of purchasing the company's works and other property, after the foreclosure of a mortgage or judicial sale." Morawetz Corp. § 812; *Symmes* v. *Union Trust Co.* (C. C.) 60 F. 830. While the term includes financial readjustments in ways other than by judicial sale, it does not properly embrace mere purchases by one company of the assets of another. *Little Rock Chamber of Commerce* v. *Reliable Furniture Co.*, 138 Ark. 403, 211 S.W. 371. Reorganization is defined in subdivisions (h) (1) (A) as including "a merger or consolidation." A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company. . . . Undoubtedly such statutes vary in the different states particularly in respect to how far the constituent companies may be deemed to survive the creation of the new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form. A sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes.

Section 203 of the Revenue Act of 1926 must be interpreted in this setting. Its purpose was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties. When describing the kind of change in corporate structure that permits exemption from these taxes, § 203 does not disregard the necessity of continuity of interests under modified corporate forms. Such is the purpose of the word "reorganization" in section 203 (b) (3) of the act, where a corporation exchanges its property "solely for stock or securities." Such also is the nature of the "merger or consolidation" described in subdivision (h) (1) (A) where a corporation acquires a majority of the stock of another, and such is the nature of the "reorganization" described in subdivision (h) (1) (B) of section 203, where a corporation transfers assets to another corporation, and the transferor, or its stockholders, immediately thereafter are in control of the transferee. The words "A recapitaliza-

tion," in subdivision (h) (1) (C) of section 203, and "A mere change in . . . form . . . of organization, however effected," in subdivision (h) (1) (D) of § 203, involve the same idea.

When subdivision (h) (1) (A) included in its definition of "merger or consolidation" the "acquisition by one corporation of . . . substantially all the properties of another," it did this so that the receipt of property by the corporation surviving the merger might serve to effect a reorganization as does an acquisition of stock. Each transaction presupposed a continuance of interest on the part of the transferor in the properties transferred. Such a limitation inheres in the conventional meaning of "merger and consolidation," and is implicit in almost every line of section 203 which we have quoted. In *Pinellas Ice & Cold Storage Co. v. Commissioner*, 57 F.(2d) 188, the Court of Appeals of the Fifth Circuit decided that a transaction almost exactly like the present was not a "merger or consolidation," but a mere sale carrying no exemption. Judge Groner's opinion in *Corbett v. Burnet*, 60 App. D.C. 202, 50 F.(2d) 492, is in accord. In defining "reorganization," § 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.

Furthermore the Cortland Company cannot come within the exception to the general rule that gains realized from exchanges of property represent taxable income unless § 203 (e) and § 203 (e) (1) apply. Under those clauses, even if the transfer to Deyo was an exchange in pursuance of a "plan of reorganization," the property received by Cortland had to include *some* "stock or securities" (§ 203 e), or the exemption could not be had. As no stock was issued against the transfer, the conditions for an exemption were not fulfilled unless the notes, all payable within fourteen months of the date of the transfer, and all unsecured, can be considered "securities" under § 203 (e). Inasmuch as a transfer made entirely for cash would not be enough, it cannot be supposed that anything so near to cash as these notes payable in so short a time and doubtless readily marketable would meet the legislative requirements.

The very reason that § 203 (e) requires that some of the property received in exchange should be "*stock or securities*" is to deprive a mere sale for cash of the benefits of an exemption and to require an amalgamation of the existing interests. There can be no justice or propriety in taxing one corporation who transfers its properties for cash and in relieving another that takes part of its pay in short time notes. The situation might be different had the "securities," though not in stock, created such obligations as to give creditors or others some assured participation in the properties of the transferee corporation. The word "securities" was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form. . . .

The orders of the Board of Tax Appeals are affirmed.

Note

1. After the *Cortland Specialty Co.* case was decided, the statutory definition of "reorganization" was amended. Under the statute as it stands today, a corporation that

transfers substantially all its assets to another corporation is permitted to receive *only voting stock* of the transferee corporation (or of a corporation in control of the transferee), except that (as a result of an amendment in 1954) not more than 20% of the property can be acquired for other property or money. Sections 368(a)(1)(C) and 368(a)(2)(B). The requirement that at least 80% of the assets be acquired for voting stock is in effect a statutory guarantee that the transferor will have a continuing interest in the transferred assets.

If the 80%-for-voting-stock requirement is not met, the exchange falls totally outside the "reorganization" category, and hence it will be a taxable exchange under §§ 1001 and 1002. Although the statute itself has thus to some extent taken over the protective function of the judicially-created doctrine of "continuity of interest," it remains important in a variety of contexts, as will be seen hereafter.

2. The decision of the Court of Appeals in the *Pinellas* case, cited in the opinion above, was affirmed by the Supreme Court. *Pinellas Ice & Cold Storage Co* v. *Commissioner*, 287 U.S. 462 (1933). The following excerpt is important:

> The "vendor" agreed "to sell," and "the purchaser" agreed "to purchase," certain described property for a definite sum of money. Part of this sum was paid in cash; for the balance the purchaser executed three promissory notes, secured by the deposit of mortgage bonds, payable, with interest, in about forty-five, seventy-five, and one hundred and five days, respectively. These notes—mere evidences of obligation to pay the purchase price—were not securities within the intendment of the act and were properly regarded as the equivalent of cash. It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well secured, short-term notes (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed. . . .
>
> Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes. (287 U.S. at 468-470.)

Two years later the Supreme Court held that a transfer of substantially all the assets of a corporation for voting trust certificates, representing 18,000 shares of common stock (worth about $540,000) of another corporation, plus about $425,000 in cash was a "reorganization" under the statute applicable to the year in question. (Moreover, at that time, cash "boot" received in a "reorganization" was not taxable to the recipient corporation if it promptly distributed it to its shareholders.) After repeating the last sentence of the foregoing quotation from its opinion in the *Pinellas* case, the Court went on

> And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation. . . .
>
> The transaction here was no sale, but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser.
>
> True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the satute. Also, a large part of the consideration was cash. This, we think, is permissable so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets. (*Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385-386, 1935).

How long must the continuity of interest last? See *Campbell* v. *Commissioner*, 15 T.C. 312 (1950).

3. It was pointed out above that in a "(C)" reorganization under the present statute, at least 80% of the assets must be acquired for voting stock. In the *Minnesota Tea* case, cited in the previous paragraph, the "continuity of interest" doctrine was held to be satisfied by a transfer for $540,000 in voting trust certificates (representing common

stock in the transferee) and $425,000 in cash. *A fortiori* a transfer solely for voting stock would have qualified. But *does* the transferor have a "definite and material interest" in the transferee, representing "a substantial part of the value of the thing transferred," if he owns an insubstantial fraction of the stock of a national company? Minnesota Tea's stake in Grand Union, its transferee, was 7½ per cent of the outstanding stock. This fact caused the Board of Tax Appeals to comment.

> Thus the transaction appears to be far from a continuing interest in the same property through a mere change in forms of ownership but rather an almost complete change in the essential assets owned. . . . 28 B.T.A 591, 595 (1933).

Transactions of this kind pose two questions of policy. Is the transfer a sale in substance if the transferor gets stock (or, if a merger or consolidation is used, stock and/or securities) of a national corporation representing a relatively minor, marketable interest in an enterprise whose financial stability is hardly at all dependent on the newly acquired assets? More broadly, do the reorganization provisions contribute toward a concentration of industrial and mercantile enterprise that the antitrust laws and other national policies are designed to discourage? If so, can transactions of this type be effectively differentiated for tax purposes from the combination of two enterprises of approximately equal size, where the formerly independent proprietors still have a substantial stake in their old assets and where the combination does not measurably contribute to a concentration of economic power? See Sandberg, "The Income Tax Subsidy to 'Reorganization'," 38 *Col. L. Rev.* 98 (1938), Butters, Lintner, and Cary, *Effects of Taxation Corporate Mergers* (1951).

The House version of the 1954 Code distinguished between closely held and publicly held corporations by allowing publicly held corporations to obtain the tax advantages of the reorganization provisions by any statutory merger or consolidation that qualified under state law, but requiring closely held corporations to meet other qualifications as well. The reason for imposing greater restrictions on closely-held corporations was stated in the House Report (p. 39) as follows.

> Publicly held corporations usually have a corporate existence separate from that of their shareholders and as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level. There is ample evidence, however, that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates.

The Senate rejected the proposal, saying (S. Rept. p. 42):

> Not only is it difficult, if not impossible, to formulate satisfactory definitions as to the types of corporations which will be deemed "publicly held" or "closely held" for tax purposes, but there is considerable doubt as to whether it would be sound policy for the tax laws to impose greater restrictions on a class of corporations which is ordinarily small than on their larger competitors.

LeTULLE v. SCOFIELD

Supreme Court of the U. S., 1940
308 U.S. 415, reh. den. 309 U.S 694

MR. JUSTICE ROBERTS delivered the opinion of the Court.

We took this case because the petition for certiorari alleged that the Circuit Court of Appeals had based its decision on a point not presented or argued by the litigants, which the petitioner had never had an opportunity to meet by the production of evidence.

The Gulf Coast Irrigation Company was the owner of irrigation properties. Petitioner was its sole stockholder. . . . November 4, 1931, the Irrigation Com-

pany, the Gulf Coast Water Company, and the petitioner, entered into an agreement which recited that the petitioner owned all of the stock of the Irrigation Company; described the company's properties, and stated that, prior to conveyance to be made pursuant to the contract, the Irrigation Company would be the owner of certain other lands and irrigation properites. . . . The contract called for a conveyance of all the properties owned, and to be owned, by the Irrigation Company for $50,000 in cash and $750,000 in bonds of the Water Company, payable serially over the period January 1, 1933, to January 1, 1944. The petitioner joined in this agreement as a guarantor of the title of the Irrigation Company and for the purpose of covenanting that he would not personally enter into the irrigation business within a fixed area during a specified period after the execution of the contract. . . .

The contract between the two corporations was carried out November 18, with the result that the Water Company became owner of all the properties then owned by the Irrigation Company. . . . The [Irrigation Company] reported no gain for the taxable year in virtue of its receipt of bonds and cash from the Water Company. The Commissioner of Internal Revenue assessed additional taxes . . . against the petitioner as transferee of the Irrigation Company's assets in virtue of the gain realized by the company on the sale of its property. The tax was paid and claims for refund were filed. . . . The respondent's contention that the transaction amounted merely to a sale of assets by the petitioner and the Irrigation Company and did not fall within the statutory definition of a tax-free reorganization was overruled by the District Court and judgment was entered for the petitioner.

The respondent appealed, asserting error on the part of the District Court in matters not now material and also assigning as error the court's holding that the transaction constituted a nontaxable reorganization.

The Circuit Court of Appeals concluded that, as the Water Company acquired substantially all the properties of the Irrigation Company, there was a merger of the latter within the literal language of the statute, but held that, in the light of the construction this Court has put upon the statute, the transaction would not be a reorganization unless the transferor retained a definite and substantial interest in the affairs of the transferee. It thought this requirement was satisfied by the taking of the bonds of the Water Company, and, therefore, agreed with the District Court that a reorganization had been consummated. It added, however, "We find a reason for reversing the judgment which has not been argued."

[Explanation of the Court of Appeals' reason for reversing the District Court is omitted. Ed.]

We find it unnecessary to consider petitioner's contention that the Circuit Court of Appeals erred in deciding the case on a ground not raised by the pleadings, not before the trial court, not suggested or argued in the Circuit Court of Appeals, and one as to which the petitioner had never had the opportunity to present his evidence, since we are of opinion that the transaction did not amount to a reorganization and that, therefore, the petitioner cannot complain, as the judgment must be affirmed on the ground that no tax-free reorganization was effected within the meaning of the statute.

Section 112(1) provides, so far as material:

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) . . .

As the court below properly stated, the section is not to be read literally, as denominating the transfer of all the assets of one company for what amounts to a cash consideration given by the other a reorganization. We have held that where the consideration consists of cash and short term notes the transfer does not amount to a reorganization within the true meaning of the statute, but is a sale upon which gain or loss must be reckoned.[1] We have said that the statute was not satisfied unless the transferror retained a substantial stake in the enterprise and such a stake was thought to be retained where a large proportion of the consideration was in common stock of the transferee,[2] or where the transferor took cash and the entire issue of preferred stock of the transferee corporation.[3] And, where the consideration is represented by a substantial proportion of stock, and the balance in bonds, the total consideration received is exempt from tax under Sec. 112(b)(4) and 112(g).[4]

In applying our decision in the *Pinellas* case, *supra*, the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. There has naturally been some difficulty in classifying the securities involved in various cases.

We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute.

We conclude that the Circuit Court of Appeals was in error in holding that, as respects any of the property transferred to the Water Company, the transaction was other than a sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange. . . .

The judgment of the Circuit Court of Appeals is affirmed and the cause is remanded to the District Court with directions to proceed in accordance with the opinion and mandate of the Circuit Court of Appeals.

So ordered.

Affirmed and remanded.

[1] Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 53 S. Ct 257, 77 L Ed 428.

[2] Helvering v. Minnesota Tea Co, 296 U.S. 378, 56 S. Ct. 269, 80 L. Ed. 284.

[3] John A. Nelson Co. v. Helvering, 296 U.S. 374, 56 S. Ct. 273, 80 L. Ed. 281.

[4] 45 Stat. 816, 818, 26 U.S.C.A. Int. Rev. Acts, pages 377, 379. See Helvering v. Watts, 296 U.S. 387, 56 S. Ct. 275, 80 L. Ed. 289

Note

1. Like the *Cortland Specialty Co.* case, *supra*, p. 566, this opinion is concerned with a transaction that would not be a "reorganization" under the present statute. At least 80% of the assets must be acquired for voting stock: § 368(a)(1)(C). But the issue in the case can arise in other transactions that do meet the literal requirements of § 368(a)-(1), *e.g.*, a merger or consolidation.

2. In *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935), approved in the *LeTulle* case, the Court had found that a transfer of substantially all of a corporation's property for $2,000,000 in cash plus non-voting preferred stock of the transferee worth (apparently) $1,250,000 qualified as a "reorganization." And in *Helvering* v. *Watts*, 296 U.S. 387 (1935), also approved in the *LeTulle* case, a transfer of all the stock of a corporation for $1,000,000 of the transferee's common stock and about $1,200,000 of bonds of the transferred corporation guaranteed by the transferee was held to be a "reorganization."

3. The record in *LeTulle* v. *Scofield* does not include a balance sheet for the Water Company. If the bonds received by the transferor represented a substantial part of the Water Company's liabilities, should not the continuity of interest doctrine be regarded as satisfied? Contrast, as to "continuity of interest," these possibilities for the owner of a one-man corporation:

(a) A statutory merger in which the individual exchanges his stock for $500,000 of bonds in the successor corporation whose balance sheet is as follows:

Assets	$1,000,000	Bonds	$ 500,000
		Common stock (stated capital plus surplus)	500,000
	$1,000,000		$1,000,000

(b) A statutory merger in which the transferor exchanges his stock for $500,000 (market value) of stock in the successor whose balance sheet looks like this:

Assets	$25,000,000	Bonds	$15,000,000
		Common stock (stated capital plus surplus)	10,000,000
	$25,000,000		$25,000,000

Do the bonds in (a), or the stock in (b), confer the more substantial, definite, and material interest in the transferred assets?

4. In *Neville Coke & Chemical Co.* v. *Commissioner*, 148 F.2d 599 (3d Cir. 1945), it was held that noteholders of a reorganized corporation who exchanged their notes for debentures and common stock could not claim nonrecognition of their gain under what is now § 354. The Court relied on the *Pinellas* case and on *LeTulle* v. *Scofield* as establishing that notes *received* on an exchange do not evidence a continuing interest in the enterprise and are not "securities." It then held that notes are equally deficient if *given up* in the exchange. The debtor was in financial difficulties at the time of the exchange, but the Court was unwilling to find that the creditors already owned the entire equity, see *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), and in fact the old stockholders did participate in the exchange. If, however, the creditors of a distressed corporation in reorganization *receive* stock or securities evidencing a proprietary interest in the enterprise, is it not probable that the claims they *gave up*, whatever their form, already represented in economic reality a proprietary interest in the assets? For a forceful statement of this view, see Griswold, " 'Securities' and 'Continuity of Interest,' " 58 *Harv. L. Rev.* 705 (1945). In the case of a solvent and successful, rather than financially distressed, corporation, should bondholders recognize gain or loss on exchanging their bonds for stock?

ROEBLING v. COMMISSIONER

U. S. Court of Appeals, Third Circuit, 1944
143 F.2d 810

Before JONES and MCLAUGHLIN, Circuit Judges, and KALODNER, District Judge.

KALODNER, District Judge.

This appeal presents three questions: (1) Whether the transaction hereafter stated between a lessor corporation and a lessee corporation constituted a "statutory merger," within the meaning of § 112(g)(1)(A) of the Revenue Act of 1938; (2) whether the doctrine of "continuity of interest" as enunciated in *LeTulle* v. *Scofield*, 308 U.S. 415, 60 S. Ct. 313, 84 L. Ed. 355, applies to a "statutory merger," and (3) whether under the facts a "continuity of interest" actually existed.

Taxability on gain resulting to the petitioner on the exchange of stock in the lessor corporation for bonds of the lessee corporation under the provisions of § 112(b)(3) of the Revenue Act of 1938 depends on the disposition of the issues above stated.

The facts are all stipulated. Summarized they are as follows:

Petitioner, an individual residing in Trenton, New Jersey, filed a Federal income tax return for the calendar year 1938 with the Collector of Internal Revenue for the First District of New Jersey.

On December 5, 1935, petitioner acquired by gift 166 shares of the stock of South Jersey Gas, Electric and Traction Co. (hereinafter referred to as South Jersey). This stock had been acquired by petitioner's donor on March 12, 1914, at a cost of $16,600.

South Jersey was a corporation organized on August 31, 1900, under the laws of the State of New Jersey, for the purpose of furnishing electricity and gas for public and private use in that state.

In June, 1903, South Jersey had leased all its franchises, plants and operating equipment to Public Service Corporation of New Jersey for 900 years. The lessee was to pay rent which beginning December 1, 1908, amounted to $480,000 per annum. In addition the lessee agreed to pay the interest charges on the lessor's bonded indebtedness, all taxes, insurance and such sums as were necessary to maintain, repair, improve and extend the leased properties. *All replacements and additions became the property of South Jersey subject to the terms of the lease.*

The lease further provided that *upon default of the terms of the lease* for a period of 30 days, after notice, *South Jersey could terminate the lease, reenter and reacquire the property and additions and extensions thereto.*

Under the terms of the lease South Jersey could enter upon the leased property for the purpose of inspecting it and determining its condition and the character of the management and whether the covenants of the lease were being complied with.

In July, 1924, this lease was assigned by Public Service Corporation of New Jersey to Public Service Electric and Gas Company which assumed the obligations thereof. . . .

Public Service Electric and Gas Company as a part of its unified electrical sys-

tem held and operated under long-term leases the properties of many other utility companies. For more than ten years Public Service and its parent, Public Service Corporation of New Jersey, had engaged in a systematic effort to acquire the fee to these properties, and by 1927 had acquired more than two-thirds of the stock of certain of these lessor companies.

On May 10, 1937, the directors of South Jersey and of Public Service Electric and Gas Company adopted a "Plan of Reorganization" under which it was proposed that the former company be merged into the latter in accordance with the statutes of New Jersey. This plan provided that the stockholders of South Jersey (other than Public Service Electric and Gas Company) should exchange, dollar for dollar, their stock in South Jersey for 8 per cent one hundred years first mortgage bonds of Public Service Electric and Gas Company. These bonds were to be issued under a prior mortgage of Public Service Electric and Gas Company dated August 1, 1924, and under a supplemental indenture later to be executed. It was expressly provided in the "Agreement of Merger" executed on the same day: "The capital stock of the Public Service Electric and Gas Company . . . will not be changed by reason of this agreement." . . .

The "Agreement of Merger" was consummated pursuant to its provisions. In accordance therewith the taxpayer received in exchange for his 166 shares of stock in South Jersey, $16,600, principal amount of 8 per cent bonds which on November 25, 1938, had a fair market value of $34,777.

The Commissioner determined that the difference between the basis of the taxpayer's stock in South Jersey and the fair market value of the bonds received in exchange therefor must be recognized as taxable income in 1938 and he asserted a deficiency which the Tax Court sustained, so far as it was based upon this item.

The issues presented here arise by reason of taxpayer's contention (1) that the merger of South Jersey into Public Service Electric and Gas Co. was a "true statutory merger" under the laws of the state of New Jersey and therefore the exchange of stock for bonds was not a taxable event under § 112 of the Revenue Act of 1938; (2) that since there was a "true statutory merger" the "continuity of interest" doctrine in the *LeTulle* v. *Scofield* case is inapplicable and (3) that in any event a "continuity of interest" actually existed in the instant case.

As to the taxpayer's first two contentions, which may be considered together: The admitted fact that the merger of the two corporations was a "true statutory merger" under the New Jersey law is not dispositive of the question as to whether there was a "statutory merger" here within the meaning of Sec. 112(g)(1)(A). It is well-settled that a State law cannot alter the essential characteristics required to enable a taxpayer to obtain exemption under the provisions of a Federal Revenue Act.

We so held in *Commissioner of Internal Revenue* v. *Gilmore's Estate*, 3 Cir., 130 F.2d 791. Indeed that case is completely dispositive of the taxpayer's first two contentions. In *Gilmore's Estate* we found that though there was, in that case, a "true statutory merger" under the identical laws of New Jersey involved here, (1) such "true statutory merger" is insufficient without more to qualify as a "reorganization" under the Revenue Act, and (2) that a "continuity of interest" as enunciated in numerous decisions of the Supreme Court of the United States and

the pertinent Treasury Regulation[1] must still be present to establish a true reorganization. In *Gilmore's Estate* we said, on page 794:

> It is now settled that whether a transaction qualifies as a reorganization under the various Revenue Acts *does not turn alone upon compliance with the literal language of the statute.* The judicial interpretation has determined that something more may be needed and that, indeed, under some circumstances, something less will do. Our concern in this case is the "something more" since we have concluded that there was a literal compliance. . . .
>
> The reorganization provisions were enacted to free from the imposition of an income tax purely "paper profits or losses" wherein there is no realization of gain or loss in the business sense *but merely the recasting of the same interests in a different form,* the tax being postponed to a future date when a more tangible gain or loss is realized. . . . (emphasis supplied)

Morgan Manufacturing Co. v. *Commissioner*, 4 Cir., 124 F.2d 602, is in agreement with our ruling in *Gilmore's Estate.* In *Helvering* v. *Alabama Asphaltic Limestone Co.*, 1942, 315 U.S. 179, at page 182, 62 S. Ct. 540, at page 542, 86 L. Ed. 775, the Supreme Court of the United States succinctly stated the rule as follows.

> From the *Pinellas* case, *Pinellas, Ice & Cold Storage Co.* v. *Commissioner of Internal Revenue*, 287 U.S. 462, 53 S. Ct. 257, 77 L. Ed. 428, to the *LeTulle* case, *LeTulle* v. *Scofield*, 308 U.S. 415, 60 S. Ct. 313, 84 L. Ed. 355, it has been recognized that a transaction may not qualify as a "reorganization" under the various revenue acts though the literal language of the statute is satisfied. See Paul, *Studies in Federal Taxation* (3d Series), p. 91 *et seq.* The *Pinellas* case introduced the continuity of interest theory to eliminate those transactions which had "no real semblance to a merger or consolidation" (287 U.S. page 470, 53 S. Ct. [257] 77 L. Ed. 428) and to avoid a construction which "would make evasion of taxation very easy.". . .

That § 112 has made "the continuity of interest test . . . much stricter" was held in *Helvering* v. *Southwest Corporation*, 315 U.S. 194-198, 62 S. Ct. 546, 550, 86 L. Ed. 789. Said the Court, page 198 of 315 U.S., at page 550 of 62 S. Ct.: " . . . [C]lause (B) of § 112(g) (1) of the 1934 Act effects an important change as respects transactions whereby one corporation acquires substantially all of the assets of another. See S. Rep. No. 558, 73d Cong., 2d Sess., Committee Reports, Revenue Acts 1913-1938, pp. 598-599. *The continuity of interest test is made much stricter.* See Paul, *Studies in Federal Taxation* (3rd Series), pp. 36-41. . . ." [2] (Emphasis supplied)

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[1] Treasury Regulation 118, § 112(g)-1(b) reads as follows

"The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. . . . Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule"

[2] Following is an excerpt from the Committee Report referred to in Helvering v Southwest Corporation:

"Your committee is in complete agreement with the purposes of the House bill which aim at tax-avoidance schemes in this connection However, some modifications are recommended in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State The committee believes that it is desirable to permit reorganizations in such cases with restric-

In view of the cases cited we cannot subscribe to the taxpayer's contention that under § 112(g)(1)(A) of the Revenue Act of 1938 the requirements of New Jersey law supersede the "continuity of interest" test as applied in *LeTulle* v. *Scofield* and the numerous other decisions.

The taxpayer's remaining contention that the requisite "continuity of interest" is present under the peculiar facts in this case is premised on a rather novel theory. He urges that "prior to the merger, the stockholders of South Jersey had *no proprietary interest* in its properties in any real sense," and that in sanctioning the merger "the decision of the New Jersey courts recognized that the stock in the lessor companies was substantially equivalent to a perpetual 8 per cent bond."

This contention places the taxpayer in an anomalous position. Whereas the "continuity of interest" principle is predicated on the existence of a proprietary right which must be carried over into the reorganized corporation, the taxpayer at one and the same time asserts that a "continuity of interest" existed in the reorganized company, even though there was *no* proprietary interest by the stockholders in the merged corporation to be carried over into the reorganized corporation.

It is unnecessary, however, to further explore this contention because two things are so clear that he who runs may read. First, the stockholders in South Jersey had a definite and clearly fixed proprietary interest in its property. The lease provided that all replacements and additions to the leased property were to be the property of South Jersey and subject to the terms and conditions of the lease. Further, on the expiration of the lease all the property subject to its terms was to be returned to South Jersey. South Jersey owned the property under lease even though that lease was for a 900-year term. The lease further provided that upon default of its terms South Jersey could terminate the lease and *re-enter and re-acquire the property and additions and extensions thereto.*

In view of the incontrovertible facts the taxpayer's argument that the stockholders in South Jersey had *no* proprietary interest is without basis.

Finally, it is equally clear that when the stockholders of South Jersey exchanged their stock in that corporation for the long-term bonds of Public Service Electric and Gas Company, they surrendered their proprietary interest and simply became creditors of Public Service. They no longer owned any of the former property of South Jersey and they had no proprietary interest in the property of Public Service. The Tax Court succinctly described the situation when it stated:

> . . . *It follows that no continuing stake in the merged enterprise was retained by South Jersey or its stockholders, and hence that the requisite continuity of interest is not furnished either by the proprietary interests acquired by the merged corporation, nor by the bondholders' status conferred upon the former shareholders.* (emphasis supplied)

tions designed to prevent tax avoidance Consequently, the committee recommends the insertion in the House bill of an addition to the definition of the term 'reorganization' as follows

"'(B) the acquisition by one corporation in exchange solely for its voting stock. of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation;'

"The committee believes that these transactions, when carried out as prescribed in this amendment, are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."

Taxpayer urges that the substance of the transaction here is close to that involved in *Commissioner of Internal Revenue* v. *Neustadt's Trust et al.*, 2 Cir., 131 F.2d 528. That is not so. In the *Neustadt's Trust* case the taxpayers merely exchanged their holdings of long-term debenture bonds for an equivalent face amount of short-term debenture bonds and both the Tax Court and the United States Circuit Court of Appeals for the Second Circuit ruled that the transaction was part of a "recapitalization" where no transfer of assets and no change of capital stock occurred.

For the reasons stated the decision of the Tax Court of the United States is affirmed.

Note

1. Note that under the 1954 Code, even if the court had found a "continuity of interest" and hence a "reorganization," the bonds would have been "boot" under § 354 (a)(2) and § 356. The taxpayer's gain would be fully recognized, but if he had had a loss, it would not be recognized. But the effect of finding that the transaction does not constitute a "reorganization" is that gain and loss are both recognized. In the *Roebling* merger, all stockholders of South Jersey received bonds of Public Service. But if some had received bonds and others stock, and if the court had not found a continuity of interest, all would be entitled to recognize whatever gain or loss they realized on the exchange. If the transaction is a reorganization, however, those who received boot would recognize their gain (but not their loss), while the others would recognize neither gain nor loss.

2. The Court of Appeals for the Fifth Circuit expressed its approval of the *Roebling* case in *Southwest Natural Gas Co.* v. *Commissioner*, 189 F.2d 332 (5th Cir.), cert. den 342 U.S. 860 (1951), but split on whether the necessary continuity of interest was present in the case before it. There the holders of 41 per cent of the stock of the merged corporation received a total of $230,300 in cash, and holders of the remaining 59 per cent received about 16 per cent of the common stock of the continuing corporation (worth about $5,600) plus about $340,000 of its bonds (worth 90 per cent of par) and $17,800 in cash. The majority thought that the low value of the stock disqualified the transaction, while Chief Judge Hutcheson, dissenting, thought this ignored "the fundamental facts of corporate investment." He argued that the common stock conferred an interest in the corporation's future and an opportunity to participate in control that justified finding the requisite continuity of interest. The opposite view of the Tax Court and majority, he thought, displayed

> too much of sticking in the bark, too little of penetration of the controlling principle; too much of tithing, mint, anise and cummin in assessing the meaning and value of the facts, too little of a rounded view thereof; too much of the letter, too little of the spirit. . . . (189 F.2d 332, 335.)

3. The *Southwest Natural Gas Co.* case illustrates a common practice in corporate reorganizations of the type considered in this section: Some of the old stockholders may be paid off in cash while the rest participate in the reorganization by accepting securities in the transferee corporation. This practice was commented on in *Miller* v. *Commissioner*, 84 F.2d 415 (6th Cir. 1936):

> We attach no importance to the fact that some of the stockholders in the transferring corporation acquired no interest in the transferee. This is certainly not a test by which the effectuation of a merger or consolidation is to be determined, for it will rarely result when reorganizations, even in their strict literal sense, are undertaken that all stockholders will approve. It is almost universal experience that some non-assenting stock must be acquired otherwise than through the mechanics of the consolidation plan. (84 F.2d at 418-419.)

In *Reilly Oil Co.* v. *Commissioner*, 189 F.2d 382 (5th Cir. 1951), a reorganization was held to qualify under clause "(D)" although 31 per cent of the transferor's shareholders elected to receive cash. The Court said:

> We are aware of no authority or valid reason which would support the contention that all or substantially all of the transferor's stockholders must acquire an interest in the corporation before a non-taxable reorganization can be effected. (189 F.2d at 384.)

A minority of the Tax Court, 13 T.C. 919, 929 (1949), felt that all, or at least substantially all, of the transferor's stockholders must participate in the exchange. The minority's position was based upon a "textual analysis" of what is now § 368(a)(1)(D); the statute has since been slightly changed, but apparently not with this problem in mind.

Textual analysis aside, does the continuity of interest doctrine require that no large body of stockholders be paid off in cash or bonds? If a substantial part of the old stockholders sell out, should the whole transaction be regarded as a sale instead of a reorganization? The regulations under the 1939 Code contain this somewhat ambiguous statement:

> Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Regs. 118, Sec. 39.112(g)-1(b).

The problem is somewhat complicated by the fact that the 1954 Code specifically authorizes a limited amount of cash or other property to be used in a "(C)" reorganization. Section 368(a)(2). Should any inferences be drawn from this new provision about the use of cash and other property in other types of reorganizations?

In a "(B)" reorganization, the statute allows only voting stock to be employed to acquire the stock of another corporation. There is no direct way to compensate non-assenters in cash. Would it be possible for the acquiring corporation to acquire 80 per cent of the stock of the other corporation for voting stock, and to buy out the non-assenters subsequently; or for assenting stockholders of the corporation that is being acquired to buy out the non-assenters for cash, and then transfer the stock in exchange for voting stock of the acquiring corporation?

4. In a "(C)" reorganization, before 1954 the acquiring corporation could issue only its *own* stock. The parenthetical clause was added in 1954 to permit stock of a parent corporation to be transferred in exchange for assets acquired by its subsidiary, and a corresponding change has been made in § 368(b) so that the parent in such a case will be a "party to the reorganization." These statutory changes reject *Groman* v. *Commissioner*, 302 U.S. 82 (1937), and *Helvering* v. *Bashford*, *ibid.* 454; *Mellon* v. *Commissioner*, 12 T.C. 90 (1949). Will the continuity of interest requirement be harder to satisfy if stock of a parent is used instead of stock in the acquiring corporation? In an "(A)" reorganization, stock of a parent cannot be used, but the acquired assets may be transferred to a subsidiary by virtue of § 368(a)(2)(C).

5. The materials in this section have focused on the consequences of a corporate reorganization to the *shareholders* of the corporation whose assets or stock are transferred. Almost always, however, the corporation will have creditors. How are they affected by the reorganization? Do they recognize gain or loss if they surrender their claims and get in exchange stock or securities of the reorganized corporation or other claims against it?

At the outset it should be noted that the creditors will not necessarily participate in any exchange at all. Thus, in a "(B)" reorganization, where the acquiring corporation exchanges its voting stock for 80 per cent or more of the stock of the acquired corporation, the creditors of both corporations may simply ride through the reorganization, preserving intact their claims (whether long or short term, secured or unsecured, evidenced by instruments of indebtedness or not) against their respective debtors. Similarly, in a "(C)" reorganization, where the acquiring corporation exchanges voting

stock for substantially all the properties of another corporation, the latter's creditors do not necessarily participate in the reorganization. They may continue as creditors of the transferor corporation, the assets of which now consist of the acquiring corporation's stock.

Alternatively, the acquiring corporation may assume the transferor corporation's liabilities, or take the properties subject to those liabilities, still without any exchange by the creditors. Ordinarily this will not constitute "boot" to the transferee. Section 357. Nor will the creditors recognize gain or loss, since their claims have not been paid, retired, or exchanged. Moreover, § 368(a)(1)(C) states explicitly that the requirement that the acquisition be solely for the acquiring corporation's voting stock is not breached by its assuming liabilities or taking property subject to liabilities. Similarly, in both "(A)" and "(D)" reorganizations, the creditors of the old corporation need not participate in an exchange.

On the other hand, there frequently will be an exchange. The creditors may surrender bonds, debentures, or notes of one corporation and receive stock or securities of another corporation. In general, the exchange will qualify under § 354. One difficulty that may arise, however, is that short-term notes (whether given up or received) may not qualify as "securities." See further *supra*, p. 566. There may be other problems as well. If in conjunction with a "(B)" reorganization (stock for stock), the acquiring corporation issues bonds in exchange for bonds of the acquired corporation, will the transaction fall outside "(B)" altogether? If not, will the bondholders' exchange be "in pursuance of the plan of reorganization" under § 354(a)(1)? If the transaction does not qualify as a reorganization, all parties to it will recognize gain or loss; if it is a reorganization, but the bondholders' exchange does not qualify under § 354(a)(1), they (but not the stockholders) will recognize gain or loss. Similarly, under a "(C)" reorganization, if the acquiring corporation issues its own evidences of indebtedness to creditors of the transferor corporation, instead of merely assuming the liabilities, will the transaction lose its status as a reorganization? If not, will the bondholders' exchange qualify under § 354(a)(1)?

See *Stoddard* v. *Commissioner*, 141 F.2d 76 (2d Cir. 1944): Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 *Yale L.J.* 1 (1940); Clapp, "The Meaning of 'Solely' in a Section 112(g)(1)(C) Reorganization and 'Continuity of Interest,'" *9th Annual N.Y.U. Inst. on Fed. Taxation* 1249 (1951).

6 A number of special problems, not dealt with here, are encountered in the reorganization of financially distressed or insolvent corporations. See §§ 371-3; Darrell, "Creditors' Reorganizations and the Federal Income Tax," 57 *Harv. L. Rev.* 1009 (1944), Tarleau, "Some Tax Considerations in Reorganizations of Insolvent Corporations," *8th N.Y.U. Annual Inst. on Fed. Taxation* 201 (1950).

CHAPTER 7

SOME SPECIAL PROBLEMS

Section A. Undistributed Corporate Earnings

1. *Unreasonable Accumulations of Surplus*

Note: Sections 531-537 of the 1954 Code, imposing an "accumulated earnings tax," are derived, with substantial modifications, from § 102 of the 1939 Code.
See Regs. 118, Secs. 39.102-1-3.

WORLD PUBLISHING CO. v. UNITED STATES

U. S. Court of Appeals, Tenth Circuit, 1948
169 F.2d 186, cert. den. 335 U.S. 911, reh. den. 336 U.S. 915

Before PHILLIPS, BRATTON and HUXMAN, Circuit Judges.

HUXMAN, Circuit Judge.

Section 102(a) of the Internal Revenue Code imposes an additional tax upon a corporation formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of being divided or distributed; and Section 102(c) provides that the fact that earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax on shareholders unless the corporation shall prove to the contrary by a clear preponderance of the evidence.*

The Commissioner of Internal Revenue assessed additional taxes against the World Publishing Company, herein called the taxpayer, under the above Section for the years 1942 and 1943. The tax was paid, and a timely claim for a refund thereof was denied. A suit for its recovery was thereupon filed in the United States District Court for the Northern District of Oklahoma. The taxpayer has appealed from an adverse judgment.

The taxpayer, a corporation, publishing the Tulsa World, a daily newspaper in Tulsa, Oklahoma, was organized in 1906 with an original capital of $25,000.00. Through subsequent increases, its capital stock, as of December 31, 1943, stood at $1,000,000.00, consisting of 10,000 shares. Eugene Lorton, the president, owns 9,997 of these shares; his wife, Maud Lorton, owns one share; F. O. Larson, an employee, owns one share; and N. G. Henthorne, an employee, owns the

*§ 533(a) of the 1954 Code requires only a "preponderance," instead of a "clear preponderance," of the evidence. [Ed.]

remaining share. These parties have been the directors of the taxpayer since 1917.

The trial court made comprehensive findings of fact and conclusions of law. See *World Publishing Company* v. *United States*, D.C., 72 F. Supp. 886, 889. The trial court applied correct principles of law. Thus the court said: "The touchstone of liability under Sec. 102 is the purpose behind the accumulation of the income and not the consequence of the accumulation." The trial court correctly pointed out that the tax may be imposed, even though the accumulation is not unreasonably large, and under proper conditions may not be imposed although there is accumulated more than is reasonably necessary for business needs. The court also recognized that, while the Commissioner's determination is presumptively correct and casts upon the taxpayer the burden of offering evidence in opposition thereto, once such evidence is presented the presumption of correctness disappears and the question then is whether under all the evidence the taxpayer has sustained the burden placed upon him by the applicable law. Our decision then turns upon whether the finding by the trial court that the taxpayer accumulated earnings beyond the reasonable needs of the business finds support in the evidence, and if so, whether the taxpayer has sustained the burden which Section 102(c) then places upon it to overcome the effect thereof.

As in all such cases, decided cases are not decisive and have comparative value only. In footnote number one,[1] we have assembled a list of cases in which a finding under somewhat related facts that the corporation was availed of for the purpose of preventing the imposition of the tax was sustained; in footnote two,[2] we have assembled a list of cases which on somewhat related facts have reached a contrary conclusion. For obvious reasons, no analysis of these cases will be attempted in this opinion. The applicable principles of law are clear and in the end the decision in this case must rest upon its own peculiar facts and circumstances.

The taxpayer occupies an enviable financial status.[3] Thus it will be seen that in 1941, the net earnings and profits were $12,636.93, and the earned surplus was $562,521.98. In 1942, the net earnings had risen to $80,540.28, and the surplus was $643,062.26. In 1943, the net earnings increased to $96,564.21, and the earned

[1] United Business Corp v. C. I. R., 19 B.T.A. 809; Id., 2 Cir., 62 F.2d 754, Chicago Stock Yards Co v. C. I. R., 41 B.T.A. 590; Id, 1 Cir., 129 F.2d 937; 318 U.S. 693, 63 S. Ct. 843, 87 L. Ed. 1086, Trico Products Co v. C. I. R., 46 B.T.A. 346, Id., 2 Cir., 137 F.2d 424; Whitney Chain & Mfg. Co. v. C. I. R., 3 T.C. 1109; Id., 2 Cir., 149 F.2d 936; Semagraph Co. v. C. I. R., 4 Cir., 152 F.2d 62, Helvering v Nat. Grocery Co., 304 U.S. 282, 58 S. Ct. 932, 82 L. Ed. 1346; McCutchin Drilling Co. v. C. I. R., 5 Cir., 143 F.2d 480, J. M. Perry & Co. v. C. I. R., 9 Cir., 120 F.2d 123; W. H. Gunlocke Chair Co v. C. I. R., 2 Cir., 145 F.2d 791, Almours Securities, Inc., v. C. I. R., 5 Cir., 91 F.2d 427; William C. DeMille Productions, Inc., v. C. I. R., 30 B.T.A. 826; Wilson Bros. & Co. v. C. I. R., 9 Cir., 124 F.2d 606.

[2] Cecil B. DeMille Productions v. C. I. R., 31 B.T.A. 1161; Id., 9 Cir., 90 F.2d 12; Universal Steel Co. v. C. I. R., 5 T.C. 627; General Smelting Co. v. C. I. R., 4 T.C. 313; Dill Manufacturing Co v. C. I. R., 39 B.T.A. 1023; L. R. Teeple Co v. C. I. R., 47 B.T.A. 270; United States v. R. C. Tway Coal Sales Co, 6 Cir., 75 F.2d 336.

[3]

Year	Net Earnings and Profits	Earned Surplus	Year	Net Earnings and Profits	Earned Surplus
1934	$49,154.16	$488,176 20	1939	$18,826.42	$556,368.20
1935	19,871.07	488,047.27	1940	35,916.85	574,285.05
1936	34,238.10	502,285.37	1941	12,636.93	562,521.98
1937	18,250.89	520,536.26	1942	80,540.28	643,062.26
1938	37,005.52	557,541.78	1943	96,564.21	739,626 47

surplus to $739,626.47. The total assets had increased from $1,570,166.29 in 1941, to $1,595,883.13 in 1942.

The taxpayer's paper grew from a small paper with a circulation of 7,000 to a present daily circulation of 70,000 and a Sunday circulation of 110,000. In 1917, it constructed a five-story building and installed large presses. In 1927, it added four stories to its building. The presses installed in 1917 were used presses and were reconditioned in 1927. On December 12, 1939, the directors set up a reserve of $250,000.00 for the purchase of new printing presses and the acquisition of a lot and building suitable for installing such presses. In 1940, the taxpayer purchased land adjacent to its building for $60,000.00, and announced that a new building would be erected. In July, 1941, a corporation under the name of the Newspaper Printing Corporation was formed. One-half of its stock was issued to the taxpayer and the other half to the Tulsa Tribune Company, publisher of the Tulsa Tribune, a competing paper in the City of Tulsa. From that time on, the Printing Corporation printed both papers, using taxpayer's mechanical plant, and the Tribune moved its office into the taxpayer's building.

It had been the settled practice of taxpayer throughout its history to finance its expansion and its mechanical equipment from earnings. The only loan ever executed by it was one of $50,000.00, in 1927, made to complete the additional four stories to its building.

At the meeting of the Board of Directors on December 21, 1942, a resolution was adopted setting aside an additional $150,000.00 for presses and accessory equipment, and $100,000.00 for the construction of the new building, and authorizing the President to proceed with plans for the purchase of new equipment. The war ensued and the purchase of the presses and the construction of the building were temporarily rendered impossible.

Under the arrangement with the Tribune, it was agreed that the Tribune was to pay one-half of the cost of the presses and accessory equipment, but there was some doubt about its ability to meet this commitment and it was perhaps necessary that taxpayer be prepared to advance the full cost of the presses and accessory equipment. At the end of 1942, the estimated cost of the building was $150,000.00, and the anticipated minimum cost of new presses and accessory equipment was $350,000.00.

The trial court's findings that the accumulation of the 1942 and 1943 surplus profits was in excess of the reasonable needs of the business, and that the taxpayer had failed to overcome the statutory presumption arising therefrom, are binding upon us if they find support in the record. Whether the accumulated reserves exceeded the reasonable needs of the business cannot be determined from a consideration of a single factor. It is necessary to consider and view all of the facts and circumstances in the light of the setting of the taxpayer in question. The factors which the court considered in reaching its conclusion are set out concisely and clearly in its detailed findings of fact as reported in 72 F. Supp. 886, and we concur therein. No useful purpose would be served by repeating in detail what is so clearly stated in the court's findings. It is significant that the accumulated earned surplus upon the taxpayer's books as of December, 1941, was greater than the estimated minimum cost of the new presses, accessory equipment and of the building, as also is the fact that the Tulsa Tribune Company was chargeable

with one-half of the cost of the presses and accessory equipment. While there was evidence that the Tulsa Tribune Company was not presently able to meet its one-half of this obligation and that the taxpayer would perhaps be required to advance such share of the cost, the Tulsa Tribune Company's liability for its share of such cost is nevertheless pertinent in considering whether the reserves accumulated by the taxpayer were beyond the reasonable needs of its business. It is agreed that at the time these reserves were set up, the contemplated improvements could not be made on account of the war. No one knew when they would be made. It was reasonable to assume that a number of years would ensue. During this time the financial status of the Tulsa Tribune might well be expected to improve and the prosperous condition of the taxpayer to continue; and further earnings could, no doubt, be expected.

The minutes of the Directors' meeting of December 21, 1942, and other testimony upon the possibility of a diminution of profits was offered to establish the reasonableness of the reserves in question. But, if, as pointed out by the court, no further profits would be required because the reserves already exceeded the estimated cost of the contemplated improvements, such testimony has very little probative value. At most, it is but one of the factors to be considered. The court also pointed out that since the arrangement between the two publishing companies, taxpayer's profits had greatly increased notwithstanding high war time taxes. While it is not required that the reserves be spent in the year in which they are created, so long as there is a present need for the expenditure, the fact that they could not be spent for a number of years during which additional earnings might be expected, in the light of taxpayer's financial history, is a relevant factor to be considered. All this, as well as the other factors which are set out in the trial court's findings, reasonably tend to support the court's finding that the accumulation of the profits of 1942 and 1943 was in excess of the reasonable needs of the business.

The only remaining question is whether the taxpayer met the burden which the statute places upon it to overcome the presumption that it was availed of for the prohibited purposes. Such presumption arises by virtue of a finding that it accumulated profits beyond the reasonable needs of its business. Taxpayer must then negative such purpose by a clear preponderance of the evidence. Such purpose need not be the sole purpose behind the accumulation. It is sufficient if it is one of the determining purposes. We think that the trial court's finding that it did not meet the requirement of the statute finds support in the record and is, therefore, binding on us. In all such cases as this, no single factor can be pointed to as controlling. A correct answer can be reached only in considering all of the facts and circumstances of the particular business under consideration and of the owner or owners of such business. When we consider the setting of taxpayer in its particular field of endeavor, it presents a bright picture. It had grown from an original investment of $25,000.00 to a corporation having assets of $1,595,883.13. Even during the depression years, it had enjoyed substantial profits. There was nothing in the picture to indicate that these profits would not continue or even increase. In addition to this, we have, for all practical purposes, a one-man corporation. Eugene Lorton owned all but three of the 10,000 shares of stock. He receives 99.97 per cent of all earnings distributed as dividends. If the earnings for

1942 and 1943 had been distributed to the stockholders, his surtaxes would have been increased in the amount of $69,520.35. All of these facts and circumstances tend to support the conclusions of the court that the corporation was availed of for the purpose of preventing the imposition of surtax upon its shareholders.

Affirmed.

PHILLIPS, Circuit Judge (*dissenting*).

. . . At a meeting of the Board of Directors of the World on December 21, 1942, Lorton, President of the World, reported that the Printing Corporation had been formed as a part of a long-range program of improvement and expansion; that the "through-put" of newspapers through the presses had more than doubled and had resulted in an "unsound functional operating position"; that it was imperative that a new press be purchased and installed and that a new building be constructed to house it "at the earliest practicable date," and that he estimated the minimum cost of the new press at $350,000, and the new building at $150,000. Those estimates in the light of future increase in costs were not merely conservative. They were too low. Thereupon, a resolution was adopted setting aside an additional $150,000 for a press and accessory equipment and $100,000 for the construction of the new building, and authorizing the President of the World to proceed with the plans to purchase a new press and accessory equipment and to construct the new building at the earliest practical date. However, the War ensued and the purchase of the press and accessory equipment and the construction of the building were temporarily rendered impossible.

It should be noted that, while the Tribune Publishing Company was to advance one-half of the cost of the press and accessory equipment, there was much doubt that it would be financially able to meet its commitment, and it was necessary for the World to be prepared to advance full cost of the press and accessory equipment.

In 1944, the World entered into a contract for the acquisition of a new press and accessory equipment. That contract was canceled. On May 25, 1945, the World entered into a contract with Hoe & Company for the new press and accessory equipment, and made a down payment of $10,000. The World obligated itself to pay the full cost of such press and accessory equipment. The estimated cost of the new press and accessory equipment in May, 1945, was $636,489.38. The contract, however, contained an escalator clause, under which actual cost was to be computed on cost at time of delivery. The cost will be substantially in excess of the above figure.

An estimate furnished the World on August 18, 1945, by H. R. Lohman Company, of Tulsa, fixed the cost of the building at $300,000 and dismantling a building on the lot at $1600. Thereafter, a contract for the construction of the building was let on a cost plus basis. The cost will be greatly in excess of $300,000. Thus, it will be seen that the estimated cost of the press and accessory equipment and the new building in 1945 had increased to an aggregate of $938,089.38.

At the end of 1942, the World had quick assets, consisting of cash, stocks, and bonds, of $631,252.57, and current liabilities of $67,600.78, leaving an excess of $563,651.79 of quick assets over current liabilities. At the end of 1943, the World had quick assets of $859,099.53, and current liabilities of $187,837.93, leaving an excess of $671,261.60 of quick assets over current liabilities.

The World had dividends in the years 1934 to 1941, inclusive, and in 1944 and 1945.

In the years 1942 and 1943, the World set aside its net earnings, after taxes, for the expansion program and did not pay any dividends. . . .

Mr. Lorton and Mr. Henthorne testified that the World withheld distribution of dividends in 1942 and 1943, in order to have funds available to finance the expansion program and not to avoid the imposition of a surtax upon its shareholders.

Had the World distributed as dividends in 1942 the $80,430.59, held by the Commissioner to be taxable under § 102, its quick assets at the end of 1942 would have been $483,221.20, or less than the then grossly inadequate estimate of the cost of the new building and the new press and accessory equipment, leaving no liquid funds for working capital. It is obvious that the reserve set aside at the end of 1942 was not in excess of the reasonable needs of the business of the World.

The excess of quick assets over current liabilities at the end of 1943 was $671,-261.60. Viewed in the light of the earlier estimate of the cost of the new press, accessory equipment, and building, it was not necessary to withhold the distribution of dividends in the amount of $70,997.44. But, we know that by the end of 1943, costs had greatly increased and it is obvious from what it did, that the World revised upward its estimate of the cost of the press, accessory equipment, and building at the end of 1943. By May, 1945, the estimated cost of the press and accessory equipment was $636,489.38, and by August, 1945, the estimated cost of the building was $301,600. Clearly, the addition of $70,997.44 to the reserve at the end of 1943 was needed to meet justly anticipated increases in costs. In fact, it now appears that the reserves were substantially below the cost of the new press, accessory equipment, and the building, even if the Tribune Publishing Company should pay half of the cost of the press and accessory equipment, which is unlikely.

When the arrangement entered into with the Tribune Publishing Company was negotiated, $60,000 was advanced to the Printing Corporation by the World and the Tribune Publishing Company. No further advances were required. After the first six months, the Printing Corporation operated at substantial profits which were distributed monthly to the World and the Tribune Publishing Company, the Printing Corporation being a mere printing agency of the World and the Tribune Publishing Company.

The question is whether or not the World was availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of the permitted earnings or profits, instead of being distributed as dividends. Section 102(c) provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders, unless the corporation by the clear preponderance of the evidence shall prove to the contrary. The trial court found that the World has not met that burden. The findings of the trial court indicated that it placed strong reliance on the fact that the earned surplus of the World in 1941, 1942, and 1943 was in excess of the December, 1942, estimate of the cost of the new press and accessory equipment, and the building, even if the obligation of the Tribune Publishing Company to bear one-half of the cost of the press and accessory equipment should not be met. The trial court also stressed heavily the fact that the expansion program lay in the indefinite post-war future.

I cannot agree with the fact that the press and accessory equipment could not

be immediately purchased and the fact that the building could not be constructed until the cessation of the War were pertinent considerations. The presses were old and could only be operated at 50 per cent of capacity. The load of the presses was increased when the arrangement was made to print both newspapers in the World plant. The fact that it was necessary for the World to acquire a new press and accessory equipment and to construct a new building in which to house them at the earliest possible date cannot be doubted. It was imperative that the World be in a position to act quickly when it became possible to purchase a new press and accessory equipment and construct the building. Surely, a business enterprise, with obsolete and badly worn equipment, might, during the War period, legitimately set aside a reserve fund to replace that equipment when available, and to construct the building necessary to house such equipment. To do so would be ordinary business prudence.

Undoubtedly, the World could have paid its earnings out in dividends and later borrowed, from Mr. Lorton, the money needed to purchase the press and accessory equipment and construct the building, but it was under no legal obligation to follow that course. It had the legal right to pursue the policy it had followed consistently throughout its history.

Moreover, I think the trial court erred in giving consideration to earned surplus. The cost of the new press and accessory equipment and the building would have had to be paid out of quick assets, not out of earned surplus, and as I have shown above, the quick assets in 1942 and 1943 were not in excess of a reasonable estimate of the cost of the new press and accessory equipment and the building when the reserves were increased in 1942 and 1943.

The argument is made that dividends of $47,000 and $45,000 were distributed in 1945 and 1946, respectively. The World could not determine, with certainty, that it would be able to make large earnings in 1945 and 1946. Newsprint was scarce. It was rationed severely. Advertising space had to be greatly curtailed. There was a short period when the World was unable to print any advertising whatever. It seems to me it was altogether reasonable for the World to set aside funds on hand to meet its imperative expansion program and it was not required to run the hazard of obtaining that necessary reserve from uncertain future earnings.

Aside from the fact that had dividends been declared in 1942 and 1943, the income tax liability of Mr. Lorton would have been greatly increased, it seems to me there is nothing in this record to justify the conclusion of the trial court. It is my opinion that, under the undisputed facts, the dividends accumulated were not beyond the reasonable needs of the business of the World, and that the World was not availed of for the purpose of preventing the imposition of surtax upon its shareholders. . . .

For the reasons indicated, I would reverse and remand, with instructions to enter judgment for the refunds claimed.

Note

1. See § 537, added by the 1954 Code. Would it have aided the taxpayer in the foregoing case? The Senate Report states (p. 318):

It is intended that this provision will make clear that there is no requirement that

> the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax.

The Senate Report also states (p. 69–70):

> If the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year. However, subsequent events may be considered to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated.

2. What do the presumptions of §§ 533(a) and (b) add to the presumption of correctness that as a matter of course accompanies any deficiency asserted by the Commissioner? If the accumulation is undeniably beyond the reasonable needs of the business, so that § 533(a) comes into play, what kind of evidence could be offered in rebuttal? Can the penalty tax be imposed if the corporation is not a holding or investment company and if its accumulations are within the reasonable needs of the business?

What is "the business" as the term is used in § 533(a)? See Regs. 118, Sec. 39.102-3 (b). Does the last sentence of this paragraph of the regulations mean that a parent corporation may accumulate its earnings to finance a subsidiary's operations only if the subsidiary is a "mere instrumentality" as that term is used in non-tax cases imposing liability on the parent for the acts of a subsidiary?

The Senate Report states (p. 70):

> Under existing interpretations, retained earnings may be invested in a business enterprise operated directly by the taxpayer, but doubt exists as to the operation of such a business through a subsidiary corporation controlled by the taxpayer. Your committee . . . agrees with the House [see House Rept. p. 53] that where the taxpayer has 80 percent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of such other corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, a factual determination should be made as to whether the funds are employed in a business operated by the taxpayer.

The statute itself makes no reference to an 80 per cent benchmark. What is the force and effect of the committee reports on this point?

See § 534, which is new in the 1954 Code. What is its relation to § 533(a)? If the taxpayer files a statement under § 534(c) listing three "grounds" on which he relies, and the government succeeds in discrediting them at trial, will any other "ground" that may be developed at the trial be rejected as an afterthought? How detailed must the statement be—may it resemble a complaint in a civil action, or must it be like a bill of particulars, or must the taxpayer disclose his "case" ?

3. In *Helvering* v. *Chicago Stock Yards Co.*, 318 U.S. 693 (1943), involving a one-man corporation, the Court said, in answer to an argument that earnings were being accumulated to enable the taxpayer to pay off certain obligations of its subsidiaries, that the taxpayer's stockholder, had the taxpayer's surplus been distributed to him, could have equally well paid off the obligations in question. Does this suggest that despite a corporation's capital requirements, the § 531 tax may be imposed if the earnings could have been distributed to the stockholders for reinvestment by them? Are corporate needs an inadequate excuse for a failure to declare dividends if the corporation could have declared a taxable dividend of stock or bonds while retaining the funds for corporate uses?

If at the time of organization the corporation issues both common stock and notes or bonds to its organizers, is retirement of the debt at or before maturity a reasonable need of the business? Note the reference in Regs. 118, Sec. 39.102–3(a), to a "sinking fund for the purpose of retiring bonds issued by the corporation." In the *Chicago Stock Yards Co.* case, *supra*, there is a suggestion that the payment of long-term obligations might not be a satisfactory excuse for the accumulation of surplus if the obligations might be readily refinanced at the due date.

Despite this suggestion, the payment of corporate debts is often regarded as a reasonable need of the business without regard to the possibility of refinancing the obligations. See, for example, *Gazette Telegraph Co.* v. *Commissioner*, 19 T.C. 692 (1953), involving a corporation that on organization (a) issued common stock of a par value of $250,000 and ten-year promissory notes of a face amount of $250,000 to its organizers and (b) borrowed $400,000 from a bank, to acquire assets of a net value of about $900,000. Within about four years, both the notes and the bank loan were paid off. The Court found that the notes were bona fide, that the capitalization was not too "thin," and that payment of the obligations was a reasonable need of the business that justified the accumulation of earnings.

It seems less likely that the redemption of common or preferred stock will be regarded as a proper reason for accumulating surplus, though, possibly, surplus might be safely accumulated if preferred stock was issued to outsiders to raise capital and if redemption is compulsory. Note again the relation of the preferred stock dividend and § 531 in the *Chamberlin* case, *supra*, p. 528. How valid was the argument that § 531 could be avoided by the plan? If an accumulation of surplus to retire debt is more easily defended than an accumulation to redeem common or preferred stock, § 531 adds to the other pressures, *supra*, p. 481, to issue debt rather than equity securities.

4. How likely is it that § 531 will be applied to a publicly-held corporation? The only reported cases involving a corporation with a substantial number of stockholders are *Trico Products Corp.* v. *Commissioner*, 137 F.2d 424 (2d Cir.), cert. den. 320 U.S. 799 (1943), and *Trico Products Corp.* v. *McGowan*, 169 F.2d 343 (2d Cir.), cert. den. 335 U.S. 899 (1948), reh. den. *id.* 913 (1949), where, although there were more than 2000 stockholders, six stockholders owned about two-thirds of the total shares. After the corporation paid a total of about $10 million in § 531 surtaxes, and interest, a minority stockholder brought a stockholder's derivative action against the directors for subjecting the corporation to the § 531 penalty. This action was settled by a payment of about $2.5 million by the defendants to the corporation. See *Mahler* v. *Trico Products Corp.*, 296 N.Y. 902, 72 N.E.2d 622 (1947); Note, Derivative Actions Arising from Payment of Penalty Taxes Under § 102, 49 *Col. L. Rev.* 394 (1949). What conditions would have to be present for a successful stockholder's action of this type? What would have to be alleged and proved in such an action?

The House version of the 1954 Code specifically exempted corporations with more than 1,500 shareholders if no more than 10% was held by any one family. The proposal was rejected by the Senate, partly because publicly held corporations would often be unable to prove their right to the exception because their records would not disclose how much stock was owned by any one family, and partly because "this tax is not now in practice applied to publicly held corporations. . . ." (S. Rept. p. 69.)

5. Before 1954, if any part of the accumulation in the taxable year was improperly accumulated, the entire "undistributed section 102 net income" for the year was subject to the penalty tax. (This term, roughly speaking, was the corporation's net income with certain adjustments (somewhat similar to the adjustments made to convert net income into earnings and profits) to reflect the corporation's dividend-paying capacity, less dividends paid during the year.)

As a result of changes in 1954, the accumulated earnings tax is imposed (in the case of a corporation that is not a "mere holding or investment company") only on the unreasonable portion of the year's accumulation, and in addition, all corporations are allowed a minimum accumulation over the years of $60,000. (On the use of multiple corporations to get a number of $60,000 credits, see §§ 1551 and 269.) Thus if at the close of the preceding year, a corporation's accumulated earnings and profits amounted

to $35,000, and in the taxable year it accumulated $100,000 of which $30,000 was retained for the reasonable needs of the business, the "accumulated earnings credit" would be $30,000 (the amount required for business needs) plus $25,000 (the minimum credit of $60,000 less the accumulation at the close of the preceding year). The remaining $45,000, less dividends paid and with certain other adjustments, would be the base on which the tax is computed.

Under § 563 of the 1954 Code, dividends paid in the first 75 days after the end of the taxable year may be deducted in computing accumulated taxable income; this prevents the imposition of tax merely because the corporation does not distribute its earnings until shortly after the end of the taxable year.

6. For proposals to amend § 531 and generally, see Cary, "Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)," 60 *Harv. L. Rev.* 1282 (1947); Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 *Yale L.J.* 171 (1939); "Economic Effects of Section 102," (*Tax Institute Symposium*, 1951); Hall, "The Taxation of Corporate Surplus Accumulations," (Joint Committee on the Economic Report, 82d Cong., 2d sess., 1952), reviewed by Cary, 6 *Nat'l Tax J.* 197 (1953); Bolan, "Section 102; A Persistent Menace to Closely-Held Corporations," 27 *St. John's L. Rev.* 1 (1952).

LION CLOTHING CO. v. COMMISSIONER

Tax Court of the U. S., 1947
8 T.C. 1181

BLACK, Judge: The principal question in this proceeding is whether petitioner is subject to the surtax on corporations imposed by section 102 of the Internal Revenue Code, as amended, for the calendar years 1940, 1941, and 1942. . . .

The respondent did not determine, and he does not contend that petitioner was "formed" for the prohibited purpose. He did determine and he does contend that petitioner was "availed of" for that purpose. It may also be noted at the start that the respondent did not determine, nor does he contend, that petitioner was "a mere holding or investment company" as that term is used in section 102(b). It is clear, of course, that petitioner is not a mere holding or investment company, but is a very active business enterprise, with a large volume of business, a considerable number of employees, and, evidently, a very large number of customers. Petitioner was formed for the purpose of engaging in the retail sale of clothing, and during the taxable years here involved it was engaged in that business and was quite successful in its operations.

The respondent did determine and he contends that during the taxable years here in question petitioner permitted its earnings or profits "to accumulate beyond the reasonable needs of the business," as that phrase is used in section 102 (c) of the code. By virtue of section 102 (c) the accumulation of earnings or profits beyond reasonable needs is determinative of a purpose to prevent the imposition of the surtax upon the shareholders, unless the corporation by a clear preponderance of evidence proves to the contrary. See *Whitney Chain & Mfg. Co.*, 3 T.C. 1109; affd., 149 Fed. (2d) 936. . . .

We think petitioner has met its burden of proof. Upon the evidence received at the hearing, we have found as ultimate facts that during the taxable years in question petitioner did not permit its earnings or profits to accumulate beyond the reasonable needs of its business and that it was not availed of for the prohibited purpose. The reason we think that earnings and profits of petitioner were

not accumulated beyond the reasonable needs of its business is because petitioner has proved by evidence which seems convincing to us that in the year 1938 it adopted by appropriate corporate action a policy of accumulating a part of its net profits each year to be added to surplus "so that the company have funds for expansion or any unforeseen depression that might occur," and that this policy under all the circumstances of the case was a reasonable one and has been carried out, including the taxable years which we have before us. We do not think it can be said that a taxpayer's earnings were accumulated beyond the reasonable needs of the business where it is shown that the purpose of their accumulation is to retire mortgage indebtedness, to make improvements which will add to the convenience and efficiency of operation of the business, to expand operations by purchasing the interests of concessionaires, to accumulate some cash reserves as a bulwark against future depressions, and to meet unknown risks of the war and post-war period. All these things we think petitioner has proved with reasonable clarity. The facts with respect thereto are set forth in our findings of fact and need not be repeated in detail here. The following table taken from petitioner's balance sheets will show what might be termed its net quick assets and current liabilities in each of the taxable years:

Quick net asset resources	Dec. 31, 1940	Dec. 31, 1941	Dec. 31, 1942
Quick gross asset resources:			
Cash	$188,974.03	$218,143.98	$429,300.29
United States bonds	12,185.00	34,545 00	35,000.00
Union Trust Co. account.			
Cash	8,215.60	13,073.62	22,846.02
Notes receivable	8,932.09	12,231.15	13,438.06
Total	218,306 72	277,993.75	500,584.37
Deduct current liabilities.			
Due concessionaires.	59,974.20	67,252 02	103,267 07
Accrued taxes	17,048.79	44,106 40	132,673 69
Mortgage payment	20,000.00	20,000.00	20,000.00
Due stockholders on demand	53,509.01	55,051 04	55,857.99
Total	150,532 00	186,409.46	311,798.75
Quick net asset resources	67,774 72	91,584.29	188,785 62

We think petitioner has established by satisfactory evidence that in each of the taxable years it was reasonable to add accumulations to its surplus so that it would have ample funds on hand without borrowing from banks to finance the following reasonable business requirements:

	Dec. 31, 1940	Dec. 31, 1941	Dec. 31, 1942
Installation of new elevator	$ 40,000.00	$ 40,000.00	$ 40,000.00
Installation of new fixtures	50,000.00	50,000.00	50,000.00
Purchase of Hafter interest	100,000.00	100,000.00	100,000.00
	190,000.00	190,000.00	190,000 00

In addition to the above, we think petitioner has established that if and when, after the taxable years in question, clothing becomes more plentiful in supply it will be necessary to increase the size of its inventories. Petitioner estimates that

$100,000 will be needed for this purpose. We have no reason to doubt the bona fides of the estimate, considering the very large annual volume of petitioner's business. Also, when [restrictions] on credit are removed it will be necessary to increase the size of its accounts receivable. Petitioner estimates that $50,000 will be required for this purpose. Thus it will be seen that substantial amounts of cash will be necessary for these purposes, even though it may turn out that petitioner has overestimated them. When all these facts are taken into consideration, we think they are sufficient to show that in none of the taxable years did petitioner accumulate its earnings beyond the reasonable needs of the business. In 1940, the first taxable year which we have before us, petitioner's net profits before taxes were $59,353.69. Of this amount, it paid $12,742.88 to the Federal Government in income and excess profits taxes, distributed $11,000 to its stockholders as dividends, and added $35,610.81 to earned surplus. In 1941 petitioner's net profits before taxes were $104,716.15. Of this amount, $37,248 19 was paid to the Federal Government in income and excess profits taxes, $15,000 was distributed to stockholders as dividends, and $52,467.96 was added to earned surplus. In 1942, the last of the taxable years which we have before us, petitioner's net profits were $182,725.74. Of this amount, petitioner paid $116,733.44 to the Federal Government in income and excess profits taxes, disbursed $20,000 to stockholders in dividends, and added $45,992.30 to earned surplus.

Thus we see from the foregoing facts that, while petitioner in the taxable years before us had large earnings, it paid large taxes to the Federal Government, disbursed substantial cash dividends to its stockholders, and added substantial amounts to its earned surplus. In the light of the facts recited in our findings of fact, we think the additions which petitioner made in each of the taxable years to its earned surplus were reasonable in amount and were accumulated to meet the legitimate needs of the business and not to prevent the imposition of the surtax on its stockholders.

One of the cases which respondent cites and relies upon is *Whitney Chain & Mfg. Co., supra.* We think the facts of that case are very unlike those present in the instant case, and, therefore, it is clearly distinguishable. In the *Whitney Chain & Mfg. Co.* case the taxpayer had loans outstanding to its stockholders in the amount of $347,800 and an investment in an unrelated corporation in the amount of $382,800. Largely because of these facts, we held that the taxpayer corporation was availed of in the taxable year for the purpose of preventing imposition of the surtax upon its stockholders through the medium of permitting its earnings or profits to accumulate instead of being distributed.

In the instant case petitioner had no outstanding loans to stockholders. On the contrary, petitioner was indebted to its stockholders in the respective taxable years in the following sums· 1940, $53,509.01, 1941, $55,051.04; and 1942, $55,857.99. These amounts were payable to stockholders on demand. Also petitioner, unlike *Whitney Chain & Mfg. Co., supra,* had no investments in unrelated corporations. It is true that in the taxable years it owned some stock in the Hafter Co. which operated in petitioner's place of business a women's ready-to-wear department, but this was a closely related business. Petitioner had $7,763.38 invested in this Hafter Co. stock which it had acquired in 1934. The evidence shows that this women's ready-to-wear department operated by the Hafter Co. had grown to be quite profitable and the acquirement of the re-

mainder of this Hafter Co. stock was one of the expansion plans which petitioner had in view in accumulating some of its profits each year and adding them to surplus. Petitioner estimated at the end of 1942 that $100,000 would be required to buy out the stock interest of the Hafter brothers in the Hafter Co. It turned out that more than this amount was required, for in 1946 petitioner bought the 75 shares of Hafter Co. stock from the Hafter brothers for $127,000.

More like the instant case than *Whitney Chain & Mfg. Co., supra,* is *General Smelting Co.,* 4 T.C. 313, in which we held in favor of the taxpayer on an issue similar to the one we have here, on the ground that the taxpayer's business was highly competitive and that in 1938 it decided upon a plan of modernization of its plant which was to and did extend over a period of several years. See also *Dill Manufacturing Co.,* 39 B.T.A. 1023.

We hold that respondent erred in determining that the surtax under the provisions of section 102 of the code should be imposed upon petitioner's net income for each of the taxable years 1940, 1941, and 1942. Needless to say, our decision in petitioner's favor covering the taxable years before us is based upon the evidence as to those years and is no indication as to what might be the decision covering future years. Any decision for a future year would, of course, depend upon its own facts. . . .

Decision will be entered under Rule 50.

Note

Loans by a corporation to its shareholders are often regarded as a suspicious circumstance, as the court's reference to the *Whitney Chain & Mfg. Co.* case indicates. But is there anything inconsistent between such loans, if collectible, and future business needs for surplus?

HALL

THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS

Joint Committee on the Economic Report
82nd Congress, 2nd Session 1952, pp. 11–13

In the absence of a comprehensive integration of the corporate and personal incomes taxes, Congress has endeavored to meet the undistributed profits tax problem in two ways: [1] First, enactment of section 102 and its predecessor sections. In substance, this approach has been to declare that corporate earnings may not remain idle — there must be either corporate use of such earnings if retained, or they must be distributed to stockholders for their employment. Personal surtax avoidance through the corporate device is recognized and countenanced so long as undistributed corporate earnings are put to a productive use. Section 102 is not an undistributed profits tax; it may, however, create the appearance of being an undistributed profits tax because of its application to undistributed income (tax base) when idle or unemployed surplus accumulations become unreasonable in amount. Because it is a penalty tax it necessarily operates negatively rather than positively. It is erratic and imprecise in its treatment of the prohibited surplus accumulations.

[1] This excludes the code provisions applicable to personal holding companies and foreign personal holding companies.

Its erratic and imprecise character is a compound of the administrative discretion which determines its activation with reference to particular taxpayer corporations and the difficulties of applying any reasonable accurate standard of measurement to the liquid assets (resulting from surplus accumulation) for which alleged corporate use may or may not find justification. As a *penalty* tax, its purpose is not directly and of itself to produce revenue, but instead to "force" either corporate use of earnings, if retained, or their distribution in dividends. The personal and corporate income taxes are the taxing instruments the revenue yield of which will reflect the capabilities of section 102. As with any penalty device direct revenue yield is inverse to its effectiveness, assuming adequate administration.

The second method of meeting the undistributed profits problem was through a general positive levy on all retained corporate earnings at rates (1936) ranging from 7 per cent to 27 per cent (undistributed profits tax of 1936-39).[2] This surtax on undistributed profits was automatic in its application. It was intended to encourage the distribution of corporate earnings without reference to the business use to which such earnings could be put if retained by the corporation. In other words, there was no exemption from tax, even though the corporate profits were needed in the business, which profits, if retained and invested, would presumably give rise to increased profit flow and dividend distributions in the future. The only method of avoidance of this tax was by distributing the whole of the corporate net earnings. The progressive character of the tax rates operated to increase tax pressure cumulatively for distribution as the corporate earnings became larger. The undistributed profits tax was a step in the direction of integrating the corporate and personal taxes, and, to that extent, in the words of the committee of the National Tax Association on Federal Taxation of Corporations, "was of real significance in that it marked a recognition of the importance of the inequity involved in the failure to bring corporate savings fully and promptly to account for personal income tax purposes." This tax experiment came to an end in 1939. Since then (as well as before), the only barrier to tax avoidance through corporate surplus accumulations is section 102.

Certain of the more important differences between section 102 and the undistributed profits tax of 1936 may be summarized as follows:

1. Section 102 is a penalty tax and thus negative in character; the undistributed profits tax was a general levy on all retained corporate earnings and thus was positive and automatic in its application.
2. Section 102 is directed only to the idle or unjustified surplus accumulations; the undistributed profits tax applied to the total of the undistributed earnings.[3]
3. Existing corporate liquidity is a factor of *large* importance in the determination as to whether or not section 102 is applicable; existing corporate liquidity was of no importance under the undistributed profits tax, because the tax applied to the annual corporate earnings remaining undistributed.
4. Section 102 is designed to "force" out as dividends only those corporate earnings which are not of active legitimate employment within the corporation; the undistributed profits tax was intended to apply tax compulsion toward the distribution of all profits.

[2] Except for a few classes of corporations specifically exempt, *i.e.*, banks, insurance companies, etc.

[3] Except for a small specific credit which could not exceed $5,000 for corporations the adjusted net income of which was less than $50,000. [See *supra*, p. 589, for the 1954 changes in the computation of the accumulated earnings tax. Ed.]

5. Section 102 favors corporate savings if actively employed—the investment function; the undistributed profits tax penalized all corporate saving and favored the consumption function.

6. Section 102 should not be considered as performing an integrating function as to the corporate and personal taxes; the undistributed profits tax did provide a partial integration of the corporate and personal taxes.

7. Section 102 does not discriminate in general against the small and growing enterprise where growth is conditioned upon retaining and investing earnings; the undistributed profits tax did discriminate against small and growing enterprises by taxing the retained, reinvested earnings.

8. Section 102, in comparison with the undistributed profits tax, favors—if not forces—secular growth of productive capacity, and accentuates, in some measure, the amplitude of the business cycle; while the undistributed profits tax tended to retard secular growth of productive capacity, and to reduce probably the amplitude of the cycle.[4]

9. Section 102 does not apply to a corporation unless the Bureau of Internal Revenue initiates and makes a deficiency assessment under the section, the undistributed profits tax was self-assessed by the corporation.

10. Section 102 tax rates under the Revenue Act of 1936 were 25 per cent on the first $100,000 of net income subject to tax, and 35 per cent on all excess net income for corporations not subject to the surtax on undistributed profits, otherwise 15 and 25 per cent; the undistributed profits tax rates ranged from 7 to 27 per cent.

Note

Taxes on undistributed corporate earnings, like those imposed by § 531 and by the now extinct undistributed profits tax, have usually been proposed primarily because of the possibility that undistributed corporate earnings may permanently escape the individual income tax. Two other arguments in favor of such levies have been advanced from time to time. If corporate earnings are paid out to the stockholders as dividends, it is argued, they will compare all competing investment opportunities before deciding whether it is desirable to reinvest in the corporation that paid the dividends. If the corporation retains the earnings instead of declaring dividends, however, the directors may decide to expand the corporation for prestige or for other irrational motives. Moreover, it is argued that retained earnings are likely to be channeled by the corporation into investment, whereas dividends may be used by the stockholders for the purchase of consumption goods. If the national economic policy at any particular time is to foster consumption rather than investment, it may be desirable to encourage higher dividends rather than corporate reinvestment.

How effectively would these objectives be served by § 531 or by the undistributed profits tax? Section 531 clearly has its principal effect on closely-held corporations, and apparently the undistributed profits tax also had more of an impact on small than on publicly-held corporations. Lent, *The Impact of the Undistributed Profits Tax, 1936–1937* (1948). Is it likely that the stockholders of such corporations would use the dividends differently than the directors would have used retained earnings?

2. *Personal Holding Companies*

> ***Note:*** **Sections 541-547 of the 1954 Code, imposing a personal holding company tax, are derived, with minor modifications, from Sections 500-508 of the 1939 Code.**
>
> **See Regs. 118, Secs. 500-508.**

[4] It has been argued that large and active corporate surpluses will lead to overexpansion of productive capacity and initiate a recession; it is also contended that corporate surpluses serve to cushion the shock of a depression and to assist in recovery. For a brief discussion of the undistributed profits tax in relation to the corporate surplus and cyclical aspects, see M. S. Kendrick, *The Undistributed Profits Tax* (Washington, D. C.: The Brookings Institution, 1937), pp. 41–64 and 86–91.

O'SULLIVAN RUBBER CO v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1941
120 F.2d 845

Before L. HAND, CHASE and FRANK, Circuit Judges.

FRANK, Circuit Judge.

This is a petition for review of a decision of the Board of Tax Appeals, reported at 42 B.T.A. 721, which found a deficiency for 1935 in personal holding company tax of $4,198.37 and a penalty of $1,049.59.

In the disputed year petitioner was a dissolved corporation in process of liquidation. It sold its business of selling rubber heels and dissolved in 1932; since then it has not engaged in business, but has endeavored to liquidate as rapidly as possible. The original sales price, after defaults in payments, was reduced in 1935, and notes, bearing interest payable semi-annually and with serial maturities beginning in 1936, were taken for the unpaid balance of $340,000 due on the adjusted price. Prior to 1935 it had distributed in liquidation about $7 per share, but in that year, the amount available being small, it made no distribution. At least 80 per cent of its income in 1935 was derived from interest, and at least 50 per cent of its outstanding stock was owned by not more than five individuals. It came, therefore, directly within the definition of "personal holding company" in Section 351(b)(1) of the Revenue Act of 1934 [§§ 542(a)(1) and (2), 1954 Code], unless it was not then a "corporation."

Petitioner's contention is that dissolution left it with only residual powers, essential to winding up its affairs, but destroyed its status as a "corporation" within the meaning of the statute. We do not agree that dissolution puts a corporation beyond taxability. In some contexts, it is useful to refer to a dissolved corporation as "civilly dead." But while analogies and metaphors are valuable (and, some writers say, indispensable) aids to thinking, they should be used cautiously and with due regard to their essentially fictional character; carried too far, they may paralyze thought. Under the law of New York, the state of its creation, a corporation which has filed a certificate of dissolution "shall continue," for stated purposes including the collection of assets, the payment of obligations, and other acts required to terminate its affairs and business. These are corporate purposes, contemplated as such from the birth of the corporation; the declining years of a corporation are part of its life; and it would be a strange doctrine that the fulfillment of those corporate purposes, which might, and did here, require a considerable stretch of time, is beyond the reach of a tax statute as broad in its scope as Section 351(b)(1). The operation of a going concern is not a condition precedent to tax liability. Petitioner suggests no reason why its position should be held so anomalous that it does not fit into a framework in which business units of every description, of long or short duration, must share in the cost of society. This is the price of existence. To the effect that, under such a statute, a dissolved corporation is to be regarded as alive, see *Jaffee v. Commissioner*, 2 Cir., 1930, 45 F.2d 679.

. . . Since we conclude that petitioner remained a "corporation," . . . it is unnecessary to rely on the alternative ground suggested by the respondent, that

petitioner or its liquidators constitute an "association," which by virtue of Section 3797(a)(3) is to be treated as a corporation. . . .

But, urges the petitioner, the personal holding surtax was enacted to remedy the evil of the "incorporated pocket book," deliberately created to reduce the personal taxes of those who created them, and, therefore, to impose the tax upon a corporation in petitioner's position is a perversion of the Congressional purpose. We may assume that the taxpayer here was not deliberately aiming to relieve its stockholders from personal taxation. It is, however, abundantly clear that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy. "Of course, all personal holding companies were not conceived in sin — many were organized for legitimate personal or business reasons; but Congress has made little distinction between the goats and the sheep."[1] In enacting the very section being applied here, Congress was attempting to foreclose the defense, available under section 104 of the Revenue Act of 1932 [§ 531, 1954 Code] that the accumulation of profits was responsive to a legitimate business need. See Committee on Ways and Means, 73d Cong., 2nd Sess., House Report No. 704, p. 12.

The effect of this system . . . is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes.

Cf. Committee on Finance, 73d Cong. 2nd Sess., Senate Report No. 558, p. 15. It is suggestive that an earlier revenue bill, that of 1928, proposed by the House Committee on Ways and Means, contained in section 104, a definition substantially identical with section 351 of the Act of 1934, but that it was stricken by the Senate because:

As in the case of all arbitrary definitions, the effect was to penalize corporations which were properly building up a surplus and to fail to recognize business necessities and sound practices. Committee on Finance, 70th Cong, 1st Sess, Senate Report No. 960, p. 12; *cf.* Committee on Ways and Means, 70th Cong., 1st Sess., House Report No. 2, p. 17.

Having before us indisputable proof from the exactitude of Section 351 itself, reinforced by the Committee reports, that Congress wished to establish objective criteria for imposition of the tax, we cannot, by probing into corporate motives, undertake to relieve from the alleged harshness of a particular application of the statute. The Board of Tax Appeals, therefore, was correct in sustaining the deficiency asserted in personal holding company surtax. . . .

The decision of the Board of Tax Appeals is affirmed.

Note

1. Section 543(a)(5) throws into the category of personal holding company income amounts received under certain personal service contracts. For another line of attack upon such arrangements, see *Commissioner* v. *Laughton, supra*, p. 352.

2. To add insult to injury, the taxpayer was held liable (in an omitted portion of the opinion, Judge L. Hand dissenting) for the 25% addition to the tax imposed by § 6651(a) for failure to file the separate personal holding company tax return required by the pre-1954 regulations. Under the 1954 Code, only a single tax return will be

[1] Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 *Yale L.J.* (1939) 171, 203.

required, with a separate schedule (failure to file which will not result in imposition of the 25% penalty) setting forth items of personal holding company income and the names and addresses of majority stockholders. See § 6501(f).

WILSON BROS. & CO. v. COMMISSIONER

U. S. Court of Appeals, Ninth Circuit, 1948
170 F.2d 423, cert. den. 336 U.S. 909

Before DENMAN, Chief Judge, and STEPHENS and ORR, Circuit Judges.

ORR, Circuit Judge.

This cause is before us on a petition for a review of a decision of the Tax Court making a redetermination of deficiencies determined by the commissioner of personal holding company surtax for the calendar years 1938 to 1942. It is conceded that petitioner is a personal holding company as defined by § 501 of the Internal Revenue Code.

The Tax Code affirmed a determination of the Commissioner of Internal Revenue that for the purpose of computing the personal holding company surtax the petitioner was not entitled to deduct, under the provisions of § 505(b) of the Internal Revenue Code,[1] amounts claimed for depreciation and expenses of two boats for the years 1938 to 1942, inclusive. Deficiencies determined by the Commissioner were substantially reduced by the Tax Court.

The corporation was organized in 1928, and was engaged in lumber mill operations until 1938, after which time its only business was the care of securities held by it and the collection of dividends and rent. The two boats in question were transferred to the petitioner corporation shortly after its inception, but were "laid up" in 1929 after serving for several months as transporters of lumber to various ports on the West Coast. Thereafter the corporation sought purchasers or lessees for the boats. Although several offers were received, no disposition of the vessels was effected. They have been kept moored and have remained under the care of a watchman who has been responsible for their maintenance. No rent or other compensation for the use of the boats has been received since they were withdrawn from use in 1929.

Petitioner was unable to establish to the satisfaction of the Commissioner that it came within either or all of the three conditions contained in § 505(b). In fact, petitioner admits that the decision of the Tax Court, based on a literal reading of the applicable provisions of the Internal Revenue Code is correct, but insists that § 505(b) should be construed and applied in accord with its spirit rather than its

1 § 505(b) [see § 545(b) (8), 1954 Code] is as follows.

"(b) Deductions not allowed. The aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (*l*), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

"(1) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

"(2) That the property was held in the course of a business carried on bona fide for profit; and

"(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business."

letter. His argument is that a contruction of § 505(b) in accord with its purpose rather than its letter would require a deduction in computing the income tax of a personal holding company wherever a deduction is allowed for an individual. The legislative history of the act is set out at length in petitioner's brief and it is argued that a business such as conducted by petitioner was intended by Congress not to lie within the application of § 505(b).

The premise to this argument is that the adoption of § 505(b) in 1937 envisaged no more than a means of preventing individuals from escaping the full amount of their income tax liability through the device of transferring property not subject to deduction under § 23, relating to personal income tax, to wholly owned corporations and taking depreciation and expense deductions from the corporate income tax liability. In the instant case it is urged that an individual owner of the two boats would have been entitled to deductions for maintenance expenses and depreciation under §§ 23(a)(2) and 23 (*l*) of the Internal Revenue Code.

Arguments of a similar nature have been made in other cases. We think a clear, satisfactory and complete answer to the contention was made in the case of *O'Sullivan Rubber Co.* v. *Commissioner*, 2 Cir., 120 F.2d 845, 847. We concur in the statement of that court "that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy."

Prior to 1942 an individual owner of boats held as were the boats in this case would have been unable to take depreciation and expense deductions because the vessels were not used in a trade or business. In that year § 23(a)(2) and § 23 (*l*)* of the code, were amended, to allow such deductions for property held for the production of income; however, the amending statute referred expressly to individuals. No change was made in the case of personal holding companies.

The failure to alter the provisions of § 505(b) in 1942 is significant of a Congressional intent contrary to that suggested by petitioner. . . .

Petitioner cites cases in support of the thesis that statutes should be construed to incorporate the intent of Congress and to avoid absurd results. The cases so cited deal with broad statutory language as applied to situations that were patently not within a reasonable interpretation of the apparent statutory policy. Section 505(b), however, is explicit in terms, and evinces a reasonable intent on the part of Congress to distinguish between personal holding companies and other taxpayers. That the particular instance which gave rise to § 505(b) is not presented by these facts does not militate against its application to them. *O'Sullivan Rubber Co.* v. *Commissioner, supra.*

The decision of the Tax Court is affirmed.

Note

1. Section 545(b)(8) was aimed primarily at incorporated yachts, country estates, etc. Since the rent received from a 25 per cent stockholder for the use of corporate property is "personal holding company income" under § 543(a)(6), why was § 543(a)(8) necessary? Section 543(a)(6), it might be noted, has been applied in the same mechanical fashion as other personal holding company provisions. In *Hatfried, Inc.* v. *Commissioner*, 162 F.2d 628 (3d Cir. 1947), § 543(a)(6) was held to embrace the rent received by a corporation from a hotel leased by it to its sole stockholder and operated by him as an ordinary business enterprise. Section 223 of the Revenue Act of 1950

* Now §§ 212 and 167(a)(2). [Ed.]

provided that for taxable years ending in 1946-49 *only*, § 543(a)(6) shall not apply to rents received for property used by the lessee in a bona fide commercial, industrial, or mining enterprise.

A different, and permanent, corrective is adopted by the second sentence of § 543 (a)(6), adopted in 1954.

2. The personal holding company provisions are studded with traps for the unwary. "Incorporated pocket books" of the kind which the sections were intended to deflate are ordinarily operated today only under the surveillance of attorneys and accountants who see to it that income is either sufficiently diversified or promptly distributed so that no surtaxes are paid. Even with the best of supervision, however, the personal holding company is a dangerous instrument. Consider such a corporation that has no accumulated earnings and profits at the beginning of a taxable year, that receives personal holding company income during the year, and that has a recognized capital loss in an amount equal to the ordinary income. The corporation has no earnings and profits, since the capital loss reduces earnings and profits even though it does not reduce taxable income, Regs. 118, Sec. 39.115(l)-1(b)(1), and therefore it cannot distribute a "dividend." It has, nevertheless, undistributed income taxable (after payment and deduction of the corporate normal and surtax) at the rate of 75 per cent on the first $2,000 and 85 per cent on the balance. See *Saxon Trading Corp.* v. *Commissioner*, 45 B.T.A. 16 (1941), and, for somewhat comparable dilemmas, *Morris Investment Corp.* v. *Commissioner*, 156 F.2d 748 (3d Cir. 1946); *Safety Tube Corp.* v. *Commissioner*, 168 F.2d 787 (6th Cir. 1948).

In some circumstances, a corporation that becomes entangled in the meshes of § 541 may be able to escape its full rigors by a distribution at a later date of "deficiency dividends" under § 547.

3. Foreign personal holding companies are dealt with by §§ 551–557. Because the corporation itself may be beyond American jurisdiction, each United States stockholder is taxed directly on his proportionate share of the corporation's undistributed income. Taxing the stockholder on undistributed income was held constitutional in *Eder* v. *Commissioner*, 138 F.2d 27 (2d Cir. 1943), despite the fact that the undistributed income was "blocked" and could not have been transferred to the United States.

4. See generally Cleary, "Personal Holding Company Pitfalls," *11th Annual N.Y.U. Inst. on Fed. Taxation* 467 (1953); Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 *Yale L.J.* 171 (1939); Greenfield, "Personal Holding Company Status," 29 *Taxes* 795 (1951).

5. Certain regulated investment companies may elect under Subchapter M, §§ 851–855, to be subject to corporate taxation on their undistributed income *only*. These corporations, which must distribute currently at least 90 per cent of their income, are treated as conduits through which the income from diversified investments passes to their stockholders. Moreover, the corporation's long-term capital gains retain that character on distribution to the stockholders. See Rubin, "Regulated Investment Companies," 28 *Taxes* 541 (1950). The Revenue Act of 1951 added § 851(e), extending Subchapter M treatment to investment companies making "venture capital" available to other corporations engaged in technological research and development, even though the investment company controls the corporations in which its funds are invested, a previously disqualifying condition.

Section B. Partners and Partnerships

Note: **Sections 181-190 of the 1939 Code, relating to partners and partnerships, provided only a bare outline, which was filled in, if at all, only by case law and administrative practice.**

The corresponding provisions of the 1954 Code, §§ 701-771, are far more detailed. They do not reject the spirit of pre-1954 law, and to some degree they codify old cases, but there are also many modifications. The relevant sections are referred to in the editor's Notes hereafter.

SENATE FINANCE COMMITTEE

S. Rept. No. 1622, 83rd Cong., 2d sess., 1954
Pp. 376–378

Section 702. Income and credits of partner

This section [of the 1954 Code] represents no change in current law and practice. It incorporates provisions of sections 182, 183(c), 184, 186, and 189 of present law. The provision is substantially the same as section 702 of the House bill, except for minor technical and clarifying amendments.

Subsection (a) requires each partner, in computing his individual tax, to take into account separately his distributive share of certain items of income, deduction, credit, *etc.*, of the partnership. For purposes of applying this subsection, a partner's distributive share of any item is to be computed in accordance with the provisions of section 704.

Paragraphs (1) through (7) of section (a) specifically require conduit treatment with respect to several major items of income, deduction, *etc.* The first three of such paragraphs provided that each partner shall treat his distributive share of partnership short-term and long-term capital gains and losses, and gains and losses from sales or exchanges of property subject to the provisions of section 1231 (relating to certain property in a trade or a business and involuntary conversions), as though realized by the partner separately. Such gains and losses accordingly are to be added to, or subtracted from, any items of similar character realized by the partner outside the partnership.

Under paragraph (4), each partner will treat as a charitable contribution by him his distributive share of charitable contributions made by the partnership. The partner's distributive share of such charitable contributions will be taken into account in applying, at the individual level, the limitation on charitable deductions.

Under paragraph (5), each partner is credited with his share of any dividends received by the partnership for purposes of determining his dividends received credit, the dividends received exclusion, or the dividends received deduction (in the case of a corporation which is a member of a partnership). A technical amendment by your committee to this provision of the House bill makes clear that only dividends which would qualify for the dividends received credit under section 34 or the dividends received deduction under part VIII of subchapter B are considered as received by the partners separately under this paragraph.

Under paragraph (6), taxes paid or accrued by the partnership to a foreign country or possession of the United States, and with respect to which the foreign tax credit may be claimed under section 901, are attributed to the partners individually, in accordance with their respective share of such taxes. Accordingly, each partner will add his distributive share of such taxes to any similar taxes paid or accrued by him individually. The partner then has the option to apply the total

amount of such taxes as a deduction against income, or as a credit against tax, subject to the limitation on the foreign tax credit.

Paragraph (7) treats partially tax exempt interest on obligations of the United States or instrumentalities of the United States as though realized by each partner separately, in accordance with his distributive share of such income.

Paragraph (8) is a "catch-all" provision which authorizes the Secretary or his delegate to prescribe regulations to require each partner to take into account separately his distributive share of any other items of income, gain, loss, deduction, or credit, the character of which would affect the computation of the partner's personal income tax. For example, partnership gain or loss from gambling operations may be required to be segregated in order to permit individual partners to offset personal gambling gains and losses against their shares of such gains and losses realized by the partnership. Similarly, non-business income or loss may be required to be segregated for purposes of applying the net operating loss provisions to the partners separately.

Paragraph (9) provides that the total amount of taxable income or loss, exclusive of items required to be segregated by other provisions of this subsection, shall be attributed to each partner in accordance with his distributive share thereof. In general, the income or loss under paragraph (9) corresponds to the so-called "ordinary" partnership income or loss under the provisions of the 1939 Code.

Subsection (b) contains a "conduit" rule which makes clear that the character of any item realized by the partnership, and included in a partner's distributive share shall be the same as though he had realized such item directly, rather than through his membership in a partnership, from the source from which it was realized by the partnership and in the same manner.

Subsection (c) relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61(a), which defines gross income, has been amended by your committee to make clear that a partner's gross income includes his distributive share of a partnership gross income. However, under subsection (c), the determination of a partner's share of the gross income of the partnership need not be made annually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as the application of the provision permitting the spreading of income for services rendered over a 3-year period (section 1301), the amount of gross income received from possessions of the United States, and the extended period of limitations applicable to deficiences where there has been an omission of 25 per cent of gross income.

Section 703. Partnership computations

Subsection (a) combines provisions of sections 183 and 189 of the 1939 Code, effecting no change in existing law. It states that the taxable income of a partnership, although not taxable as such, shall be computed in the same manner as the taxable income of an individual, with certain exceptions. The classes of items described in section 702(a) must be separately stated. In addition, certain deductions which are applicable only to individuals are not allowed in the computation

of partnership income. These are the optional standard deduction, the deduction for personal exemptions, the net operating loss deduction, and the itemized deductions for individuals provided in part VII, such as the medical expense deduction.

The House provisions have been amended by your committee to make clear that partnerships shall not be entitled to deductions for taxes paid or accrued to foreign countries or possessions of the United States, or for charitable contributions, since such deductions are taken by the partners individually under section 702.

Subsection (b) requires that all elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. Thus, elections as to methods of accounting, methods of computing depreciation, the use of the installment sales provision, the option to expense intangible drilling and development costs, *etc.*, must be made by the partnership, and must be applicable to all partners equally. An exception is made permitting a separate election by each partner to use his distributive share of taxes paid or accrued by the partnership to foreign countries and possessions of the United States either as a credit or as a deduction. The exception as to foreign taxes does not constitute a change in existing law, although it eliminates a possible interpretation of sections 183 and 186 of the 1939 code which might permit both the credit to the partners and the deduction to the partnership.

Note

1. See § 706(a), reenacting § 188 of the 1939 Code. If two taxpayers on the calendar year basis form a partnership on February 1, 1954 and select February 1-January 31 as the partnership's fiscal year, no partnership income will be reported in their individual returns until 1955, and there will be a similar lag between income and tax in later years, resulting in a postponement of tax that may be helpful to a new and expanding enterprise. But note the restrictions of § 706(b), which are new.

A disparity between the tax years of the partner and the partnership may be reflected in a disadvantage as well. To continue with the example just given, if the partnership's taxable year should close on December 31, 1955, the 1955 returns of the individual partners must include both the February 1, 1954—January 31, 1955 income of the partnership and its February 1, 1955—December 31, 1955 income, with a consequent pyramiding of tax. *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493 (1938), see also *Girard Trust Co.* v. *Commissioner*, 182 F.2d 921 (3d Cir. 1950); *Commissioner* v. *Waldman*, 196 F.2d 83 (2d Cir. 1952). But this is less of a problem than formerly, because § 706(c) provides that the partnership's taxable year shall not close as a general rule in circumstances that before 1954 would often have produced a termination of the taxable year. Even before § 706(c) was enacted, however, there was a growing tendency to allow the taxable year of the firm to continue despite the death or retirement of one partner. See Rev. Rul. 144, 53-2 C.B. 212; *Commissioner* v. *Tyree*, — F.2d — (10th Cir. 1954).

2. See again § 1361, *supra*, p. 457, permitting certain partnerships to elect to be taxed as corporations. See also § 761(a), authorizing the Secretary by regulation to excuse certain unincorporated organizations from filing a partnership return. The Senate Report (p. 407) states: "In order for any organization to be so excluded, the members of such an organization must be able to determine their income without the necessity of computing a partnership taxable income."

HELVERING v. WALBRIDGE

U. S. Court of Appeals, Second Circuit, 1934
70 F.2d 683

Before L. HAND, SWAN, and CHASE, Circuit Judges.

L. HAND, Circuit Judge.

This is a petition of the Commissioner of Internal Revenue to review an order of the Board of Tax Appeals which reduced a deficiency in the respondent's income tax for the year 1928. The taxpayer, Walbridge, with three others, formed a partnership to trade in financial securities; he and two other partners contributed shares of stock, and the fourth gave cash. The firm sold some of the shares contributed by Walbridge at a price higher than that at which he had bought them, and higher than their value when he contributed them.* In its income tax return the firm charged itself with the difference between the sale price of the shares and the cost at which it had accepted them, and concededly Walbridge was liable for an income tax upon this proportion of that profit. But the Commissioner further charged his income with the difference between the price at which the shares had been taken by the firm and their cost to him; and it is the tax on this gain that is now at issue. Walbridge maintains that he is not taxable upon it until the firm is dissolved, at which time it will come in as a profit or loss, according as his liquidating dividend is greater or less than the original cost of the shares to him. The Board so held and the Commissioner appealed.

Under the Act of 1928, as earlier, partnerships were obliged to make returns (section 189), and their income was computed as that of an individual (section 183), but the tax was imposed upon the partners (section 182 (a)), the firm itself not being taxable (section 181). Ever since the Act of 1918 the Regulations had provided that only upon dissolution of the firm did the partner individually "realize" any gain or loss on firm transactions, and at that time his gain was the difference between his liquidating dividend and the original cost to him of his contribution. . . . Indeed if the liquidating dividend was in kind, no gain was "realized" until the property distributed was sold, a provision of doubtful validity except perhaps in cases where the dividend did not itself have any "fair market value." In the face of such long continued departmental interpretation we should be slow to construe the statute otherwise; indeed we would not do so at all unless the statute flatly required it. It does not. The relevant section is section 111 (c) of 1928, which provides that "the amount realized . . . shall be the sum of any money received plus the fair market value of the property . . . received"; the critical words are "fair market value." The section has stood in substantially this form since 1918, with the exception of the Act of 1921, § 202 (c), 42 Stat. 230, where it read, "readily realizable market value"; a more comprehensive formula, for one may at times "readily realize" on goods which have no true market, "fair" or "unfair." Art. 561 of Regs. 74, under the Act of 1928, in implementation of this section declares that although "fair market value" is a question of fact, "only in rare and

* The partnership was formed on Nov. 30, 1928. On this date the securities, which had cost the taxpayer $114,360, were worth $237,297. They were sold by the partnership for $260,104. [Ed.]

extraordinary cases does property have no fair market value." † In other connections the phrase has usually been defined as the price at which "a willing buyer" and "a willing seller" would exchange. Art. 206, Regs. 45; art. 201 (b), Regs. 62, art. 221 (b), Regs. 74. Art. 1563 of Regs. 45 expands the same notion without substantially varying this definition. The gloss we have quoted we cannot accept; "fair market value" is not nearly so universal a phenomenon as to justify such a comment, and the implication is misleading. Perhaps there need not be a "market" to establish a "market value," but there must be some assurance that the value is what a "market" would establish; and a "market" itself presupposes enough competition between buyers and sellers to prevent the exigencies of an individual from being exploited. It may well imply that the goods have several possible buyers, so that a necessitous seller shall not be confined to one; and that there are several possible sellers of the same goods or their substantial equivalent, so that a hard-pressed buyer shall not have to accept the first offer. "Willing" adds nothing, for, if the trade goes through at all, both must be willing, and the degree of their reluctance is not a serviceable measure. In the case at bar Walbridge's share in this firm, engaged in marketing securities, was not "marketable"; the assumption is wholly unfounded that it was worth the value of his contribution. Under the Partnership Law of New York (*Consol. Laws N. Y.* c. 39) § 53, a sale of a partner's interest no longer disrupts the firm; it does not transfer any interest in the firm assets, but only the assignee's rights upon an accounting and during the continuance of the firm. That goes along for its prescribed term and the eventual liquidating dividend cannot possibly be learned in advance. The decisions have so far attempted no definition of the phrase, proceeding rather by exclusion; we agree that it does not require a price determined in a conventional market like a stock or produce exchange; there are other "market" prices, recognized and accepted as such in trade. But all the cases have required some more palpable measure than any available here, which can be no more than an opinion as to the value of a unique right of action for which there were no known buyers, nor any but an imaginary demand. . . . So far therefore as the Commissioner proceeded on the theory that the value of Walbridge's share in the firm could be made the minuend in an equation determining a "recognizable gain," he was wrong.

The Commissioner's second argument treats the partnership pluralistically, as the common law did before equity intervened. His theory is that when a firm sells property contributed by a partner, it is a sale of the partner's property, and the gain may properly be divided into two parts; that which accrued before the contribution, and which can be taxed against him, and that arising thereafter, which must be taxed against the firm. Such a view ignores even the bare common-law outlines of a partnership—joint ownership and joint obligation—to say nothing of the scaffolding reared by equity to support the concept of the firm as an entity. By his transfer the partner ceases to be sole owner of what he contributes and thereafter holds jointly; his consideration is his own share in the contributions of the other partners. When the firm sells the entire interest in the contributed property the contributing partner sells only his reserved proportion, and the other partners sell their acquired proportions. If we kept very literally to the common-law view, we might say that the partner had "realized" a "gain" based upon the

† See Regs. 118, Sec. 39.111-1. [Ed.]

difference between his proportion of the selling price and the same proportion of his original cost, but that is as far as we could go. The other partners would have "realized" the difference between their proportion of the selling price and the same proportion of their cost, whatever that was; conceivably it might be either the original cost of the property to the contributing partner, in analogy with the rule as to gifts, or its value at the time of contribution. But in neither case could that gain be assessed against the partner who contributed the property, for he had no interest whatever in this part of the profit. He had altogether parted with the property except that proportion which he retained as partner; he had got for it his interest in the contribution of the other partners, and any gain to him must be measured in terms of that exchange. Moreover, he may not be taxed even upon the profit realized on that proportion of the property of which at common-law he remained owner. It was firm assets, he could not withdraw it; he had no effective power over it, and therefore no interest in it, save as it might figure in "his share of the profits and surplus." Section 52, N. Y. Partnership Law (*Consol. Laws N. Y.* c. 39). It is true that the common-law even after equity was through, had not conceived the firm as a juristic person. *Francis* v. *McNeal*, 228 U.S. 695, 33 S. Ct. 701, 57 L. Ed. 1029, L.R.A. 1915E, 706; *Harris* v. *Commissioner*, 39 F.(2d) 546 (C. C. A. 2). But for practical purposes the distribution was not very different and the legal interest of a partner as joint owner has long since lost most of its legal incidents. *United States* v. *Kauffman*, 267 U.S. 408, 45 S. Ct. 322, 69 L. Ed. 685. Thus is appears to us that the regulation provided the proper way to deal with a partner's rights, and that a necessary corollary from it is that no gain is "realized" by a separate partner when the firm sells partnership property.

Order affirmed.

Note

1. See also *Archbald* v. *Commissioner*, 27 B.T.A. 837 (1933), aff'd. p c. 70 F.2d 720 (2d Cir. 1934). In thinking through the implications of the *Walbridge* case, of a statutory change that the decision in the Board of Tax Appeals helped to bring on, and of the next case, the following illustration may be helpful: *A* and *B* each own non-depreciable property with an adjusted basis of $25,000 and a present value of $35,000. They decide to pool their resources in an equal partnership, so its assets are worth $70,000. The assets are sold for that amount by the partnership and the proceeds are invested by the firm in other property costing $70,000. Thereafter these assets are distributed to *A* and *B* in liquidation of the firm; at the time of liquidation, the distributed assets are still worth $70,000, so *A* and *B* each get property worth $35,000. Then *A* sells his property for $35,000 and *B* does the same. It is clear enough that a total of $20,000 of taxable gain ought to be reported by *A* and *B* at some stage in the described proceedings. But when?

One might argue for the earliest date, when the partnership is formed. This is when the profit would be taxed if there were a transfer to a corporation, were it not for § 351, and it could be argued by a parity of reasoning that *A* and *B* have each sold or exchanged property for an interest in the partnership. Each would then have gain in the amount of $10,000, the difference between the basis of the property given up and the value of what was received in exchange. A variation on this approach would treat the transfer by *A* as a sale or exchange of a one-half interest in his property for a one-half interest in *B's*, and vice versa. Then, unless the transactions were viewed as a transfer of property for other property of a like kind under § 1031, *A* and *B* would each recognize $5,000 of income. That is, one-half of *A*'s property, with an allocated basis of $12,500 would be regarded as sold or exchanged for one-half of *B*'s property, with a

value of $17,500, and vice versa. The rest of *A*'s and *B*'s income would be taxed at a later time, when the property is sold by the firm, when the firm liquidates, or when the assets received in liquidation are sold by *A* and *B*. But the *Walbridge* case refuses to view the transfer of appreciated property to a partnership as a taxable occasion, and its conclusion has met with general acceptance. See § 721, codifying pre-1954 case law.

Under a second approach, it might be argued that when the property was sold by the partnership for $70,000, *A* and *B* each realized and should recognize his own $10,000 gain. This theory too was rejected by the *Walbridge* case, but here its conclusion has not been accepted. In fact, a few days before the case was decided by the Court of Appeals (but with the Board of Tax Appeals' decision in mind), Congress had already enacted what is now § 723,* providing that the partnership's basis for contributed property is the same as the transferor's basis.

Why did Congress reject this part of the *Walbridge* case? Not because the *Walbridge* case meant that the pre-contribution gain of *A* and *B* would go forever unrecognized; it would be quite consistent with the *Walbridge* case for the gain to be recognized (to return to the facts of the example above) either when the reinvested proceeds of the sale were distributed in kind to *A* and *B* or when the assets thus distributed were sold by them. A clue to the legislative rejection of the *Walbridge* rule may be found in *Chisholm* v. *Commissioner*, 79 F.2d 14 (2d Cir. 1935). Although this case was decided after § 113(a)(13) of the 1939 Code (§ 723 of the 1954 Code) was enacted, it illustrates a tax technique about which Congress was concerned. Two individuals each owned 300 shares of corporate stock with a cost basis of $8,000, but a total market value of almost $1,000,000. In contemplation of a sale, they transferred the shares to a partnership, which promptly sold the shares and retained and reinvested the proceeds. Under the *Walbridge* case, the partners did not realize gain either when the firm was formed or when it sold the stock. An attempt by the Commissioner to attack the transaction along *Gregory* lines failed, the court finding that "the purpose was certainly to form an enduring firm which should continue to hold the joint principal and to invest and reinvest it".† 79 F.2d 14, 15. While gain would be recognized by the partners either when they liquidated the partnership or at the latest when they sold the proceeds received on the liquidation, those dates could be selected at their option. Moreover, death might intervene and provide a stepped-up basis under § 1014. Section 723, of course, alters this result by providing that the partnership's basis for the assets is the same as the individuals'.

When § 723 was enacted in 1934, Congress sought to have its rule applied to past transactions, through an announcement in the committee reports that the section was declaratory of existing law, but as the *Walbridge*, *Archbald*, and *Chisolm* cases indicate, this proved to be mere whistling in the dark. H. Rept. No. 704, 73 Cong., 2d sess., reprinted in 39-1 C.B. (Part 2) 554, 567–8; S. Rept. No. 558, *id.* 586, 600–1.

2. Although § 723 saddles the partnership with the partner's basis for contributed property, it does not prescribe a method for allocating the income thus computed among the partners. To vary the illustration above in order to present the problem, assume that *A* contributes securities worth $35,000 but having a basis of $25,000, while *B* contributes

* Section 113(a)(13) of the 1939 Code, from which § 723 of the 1954 Code was taken, also provided that this basis should be adjusted for any gain or loss recognized on the transfer, but, since the transfer to the partnership has not been regarded as a taxable occasion, this puzzling provision for adjustment of basis became a dead letter and was eliminated when the 1954 Code was enacted.

† In distinguishing the *Gregory* case, the court said: "In Gregory v. Helvering . . . , the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." 79 F 2d 14, 15.

$35,000 in cash. If the partnership should sell the securities for $35,000, there will be a gain of $10,000 as a result of § 723. How is it to be allocated between *A* and *B*?

Before turning to § 704(c), which for the first time provides a statutory guide to this area, we might consider several possible ways of dividing the gain. The partnership agreement itself may have something to say on the subject, though often it would be silent. In the absence of a provision in the agreement, there are three principal methods that might be adopted.

(a) The sale by the partnership could be regarded as a realization by *A* of the pre-contribution gain, and the entire $10,000 of income would then be taxed to him alone.

(b) The gain could be reported equally by *A* and *B*, if that is how post-contribution gains are shared. The basis of both *A*'s and *B*'s partnership interest would be increased by $5,000, the amount of income taxed to each though not withdrawn. With this adjustment, *A*'s partnership interest would have a basis of $30,000 and *B*'s $40,000. On ultimate liquidation or sale of his interest, *A* would have a gain of $5,000 (thus reporting in two steps his pre-contribution appreciation of $10,000), while *B* would have a loss of $5,000, to offset the $5,000 of taxable income previously reported by him when he had enjoyed no economic gain.

(c) At the time the partnership was formed, *A's* basis of $25,000 and *B's* basis of $35,000 would be redistributed among them, so that each would take a basis of $30,000 for his interest. On the sale of the securities, the $10,000 gain would be taxed to them equally, and the basis of the partnership interest of each would be increased from $30,000 to $35,000 in recognition of the taxed but retained income. There would then be no further tax to either *A* or *B* on the final liquidation or sale of his investment in the partnership or its property. *A* would ultimately be taxed on only $5,000 though he had enjoyed $10,000 of gain, while *B* would be taxed on $5,000 of gain he did not enjoy. These disparities would have certain compensations in simplicity of administration.

A choice among these methods for handling the gain or loss on contributed property that has a basis different from its value at the time of contribution is complicated by the fact that the property may be depreciable. Assume that *A* contributes depreciable property having an adjusted basis of $25,000 but a value of $35,000 and that *B* contributes $35,000 in cash. The partnership's basis for depreciation under §§ 167(f), 1011, and 723 is $25,000. Over the life of the asset, *A* and *B* together will be entitled to a total of $25,000 in depreciation deductions. But how should these deductions be allocated between them, assuming the partnership agreement is silent? Three methods, which correspond to the three methods described above for allocating the gain or loss on pre-contribution appreciation, may be noted.

(1) One method would be to allow *A* to take $7,500 of the total depreciation deductions, while allocating $17,500 to *B*. To see how this method would work out, assume that after the property contributed by *A* has been fully depreciated, the firm has left only the $35,000 contributed by *B* and that no other transactions need be accounted for. Since *A* and *B* would have equal interests in the firm's remaining assets of $35,000, *A* has in effect contributed $25,000 (his adjusted basis) to the partnership and now has an interest worth $17,500, while *B* contributed $35,000 and now also has a partnership interest worth $17,500. The depreciation deductions of $7,500 allowed to *A* under this method and $17,500 allowed to *B* will properly compensate them both for their losses.

(2) A second method would allocate the total of $25,000 in depreciation deductions equally between *A* and *B*, allowing each to adjust the basis for his partnership interest to correspond, *i.e.*, *A* would reduce his basis from $25,000 to $12,500 while *B* would reduce his basis from $35,000 to $22,500. Now if *A* sells his partnership interest (worth $17,500), he will recognize $5,000 of gain. His actual loss of $7,500 over the life of the firm (*i.e.*, $25,000 of basis for the contributed property less $17,500 received on the sale) is reflected for tax purposes by $12,500 of depreciation deductions and $5,000 of gain on the sale. *B* would recognize a loss of $5,000 on selling his partnership interest. Thus his actual loss of $17,500 ($35,000 contributed; $17,500 received on the sale) would be recognized for tax purposes in the form of $12,500 in depreciation deductions and $5,000 of loss on the sale.

(3) A third method would start with an adjustment of the basis of the partnership interests at the time the property is contributed. This adjustment, described in (c) above, would give *A* and *B* a basis of $30,000 each for their respective partnership interests. The depreciation deductions would then be allocated equally between *A* and *B*, and the basis of each partnership interest would be reduced by $12,500 to $17,500. There would then be neither gain nor loss on sales by them of their partnership interests. The net result would be a loss by *A* of $7,500 (*i.e.*, adjusted basis of contributed property was $25,000; amount received on sale was $17,500) but tax deductions of $12,500. *B* would have suffered an economic loss of $17,500 but would have deductions of only $12,500. The aggregate of deductions ($25,000) would correspond with the aggregate losses ($25,000), but the allocation between *A* and *B* would be unfair. Just as this method produces an inaccurate allocation of gain if the property is sold, so it produces an inaccurate allocation of depreciation; but for both purposes it is easier of application

Of these methods, the first was adopted by the Bureau of Internal Revenue in G.C.M. 10092, XI-1 C.B. 114 (1932). This ruling was revoked in 1950 by G.C.M. 26379, 50-1 C.B. 58, but the Bureau did not then endorse another method. The American Law Institute Draft of a revised Internal Revenue Code recommended adoption of the third method, with provision for an election to employ either of the other two. See Jackson, Johnson, Surrey, and Warren, "A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft," 9 *Tax L. Rev.* 109, 119–133 (1954); Little, *Federal Income Taxation of Partnerships*, 112–23 (1952); Note, Partnership and Partner: The Problem of Contributed Property, 35 *A B.A.J.* 943 (1949); Dibble, "Allocations of Partnership Profits and Losses," 1950 *So. Calif. Tax Inst.* 43.

The 1954 Code provides, in § 704(c)(1), for use of the second method as a general rule. But § 704(c)(2) permits the partnership agreement to provide for a different allocation "so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." The Senate Report (pp. 381–2) uses the first method as an illustration of a permissible method under § 704(c)(2). It is not clear whether the third method would be permissible; it requires a determination of the partners' bases for their interests in the firm at variance with that prescribed by §§ 705 and 722; but see § 705(b) and Senate Report p. 384. Section 704(c)(3), relating to undivided interests in contributed property, in effect permits the contributed property to be segregated from the rest of the partnership property, with gain, loss, depreciation, *etc.* treated as though it were still owned by the individual partners.

3. Assume that *A* and *B* share equally in the profits of a partnership that in a given year has a total taxable income of $50,000, of which $5,000 is tax-exempt interest on municipal bonds and $20,000 is long-term capital gain. May the tax-exempt interest and capital gain be allocated to *A*, a high bracket taxpayer, and the ordinary income to *B*, who is either in a low bracket or has offsetting losses on non-partnership transactions? See §§ 704(a) and (b).

CRAWFORD v. COMMISSIONER

Board of Tax Appeals, 1939
39 B.T.A. 521

HILL: . . .

Petitioners filed this proceeding . . . for a determination by the Board of an alleged overpayment of taxes amounting to $39,883.56 for said year. . . . The facts are stipulated.

The petitioners are executors of the will of George W. Crawford, deceased. During his lifetime the decedent was a one-fourth co-owner of the Venempa

Investment Co., a partnership, formed December 26, 1938, in Pittsburgh, Pennsylvania, to engage in buying, selling, and dealing in stocks, bonds, and other commercial securities. Including contributions made at the time of the partnership's organization, each of the four partners paid in to its capital cash in the amount of $262,815.96, and securities for which they were given capital credits on the partnership books. The securities contributed by the decedent included 10,000 shares of Western Public Service Corporation stock which cost him $25,200 when acquired in 1928; also, two blocks (of 1,250 shares each) of Lone Star Gas Corporation stock, each block costing $5,195.27 when purchased. The 10,000 shares of Western Public Service Corporation stock had a fair market value of $283,125 when contributed to the partnership, and decedent received a credit upon the partnership books in the amount of their cost ($25,200) for the same. The two blocks of Lone Star Gas Corporation stock had fair market values in the respective amounts of $82,812.50 and $81,250 when contributed to the partnership, and decedent received a credit therefor upon the partnership books in the respective amounts of $81,250 and $50,000.

In and during the years 1928 to 1932, inclusive, the partnership had net earnings which, for the whole period, exceeded its losses. It distributed no part of its earnings to members and, at the end of 1932, had on hand undistributed earnings, represented principally by investments in securities, of which the value of decedent's partnership interest amounted to $128,250.65. On December 31 of the latter year the partnership was dissolved by mutual consent and its assets distributed. The decedent received in this distribution $83.69 in cash and securities of a total market value amounting to $233,500.

In decedent's income tax return for 1932 no deduction from gross income was claimed for any loss sustained in liquidating his interest, as aforesaid, in the partnership. The petitioners claim, and ask us to find in this proceeding, that a loss was sustained in that transaction, and that failure to take a deduction for it in decedent's income tax return for 1932 resulted in an overpayment of taxes in the amount of $39,883.56. The issue is governed by the Revenue Act of 1932, and the pertinent provisions of Treasury Regulations No. 77.

Relating to "Readjustment of Partnership Interests," article 604 of Regulations 77,* among other things, provides that when a partner retires from a partnership, or it is dissolved, the partner realizes a gain or loss measured by the difference between the *price received* for his interest and the *cost to him* of such interest, including in such cost the partner's share in undistributed partnership net income on which income taxes have been paid. Also, that if in a dissolution the partnership assets are distributed to the members *in kind and not in cash*, the partner *realizes no gain or loss until he disposes of the property received in liquidation.*

The petitioners contend that by virtue of the provision first above mentioned, a loss to the decedent through liquidation of his partnership interest is established. That this loss is the amount by which the cost of his partnership interest exceeds the cash ($83.69) and the market value ($233,500) of the assets distributed to him.

The parties are in accord on the cost of decedent's partnership interest. They also agree what the "market value" of all assets distributed to decedent was when the partnership was dissolved. However, at the time the return here involved was filed, the assets distributed to decedent had not been disposed of, and the respond-

* See Regs. 118, Sec. 39.113(a)(13)-2. [Ed.]

ent contends that, under the provision of the regulation last above mentioned, no gain or loss may be recognized until a sale or disposition of them has been made. The petitioners counter this contention with the argument that application of the provision is logical and proper, only when applied to cases where the assets distributed in a partnership liquidation have no determinable value. They argue that where basic values are agreed upon, as in the case at bar, the actual gain or loss is *ipso facto* established and must be recognized under the provisions of such regulations, as well as under the provisions of section 111 of the Revenue Act of 1932 [§ 1001, 1954 Code], reading as follows:

(a) Computation of Gain or Loss.—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b), and the loss shall be the excess of such basis over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

The petitioners also contend that the effect of respondent's holding in the premises is to place an unconstitutional construction upon and render void the provision of the regulation relied upon by him.

In pressing their argument that the challenged portion of the article is illegal, and therefore void, the petitioners admit in their brief that they know of no case directly in point, but cite *Helvering* v. *Walbridge*, 70 Fed.(2d) 683, where the court in its opinion by way of *dictum* referred to the provision as "of doubtful validity," except in cases where the asset dealt with had no fair market value. Petitioners also quote "Magill" on taxable income,† where that author in discussing a related phase of the problem of partnership gains refers to reasons given by the Advisory Board of the Treasury for the rule of construction here applied by the respondent, as "not wholly convincing."

In our opinion the portion of the regulation objected to by the petitioners is reasonable in its application to the facts before us and must be sustained. Obviously, the petitioners misconstrue the exact character of the transactions which, they conclude, resulted in a loss to the decedent. The net effect of petitioners' reasoning is that, when a partnership dissolves and distributes its capital assets among members, each member *disposes* of his partnership interest for a price, or that he receives such distribution in cancellation or redemption of an interest in the partnership. The fact is that such distribution does not confer title to the assets upon the members, but is merely an apportioning among them of what they already owned jointly. Petitioners' decedent and others contributed securities and cash to a fund to be used in the partnership business. The partnership operated this fund over a period of years. The net profits from such operation were taxable distributively to the members of the partnership and likewise the net losses of the operation were deductible proportionately by the members in determining their income tax liability. What remained of the fund at the dissolution of the partnership was the property of the members and was the residuum of what they had contributed to the fund. The partnership fund was at all times the property of the members and neither the dissolution of the partnership nor the distribution of the fund affected such ownership in any way.

† Magill, *Taxable Income* (rev. ed. 1945) pp. 134–138. [Ed.]

The fallacy of petitioners' assumption is clear when one considers the character of partnerships. An ordinary partnership, such as we have here, has no entity in the sense that it may own property separate and apart from the ownership thereof of its members. The members, at all times, own the partnership business and the assets employed in it, and are, therefore, never separated from title thereto. The dissolution of the partnership in question in no way affected the title to the assets of the partnership fund but the title to such assets, which, *ab initio* had rested in the members, continued in them. Accordingly, the distribution of assets which took place upon dissolution of the partnership neither added to, nor took from, the economic interests of the partners. The net effect of the process was not to create new interests and values, but merely to apportion and deliver to each member, according to his ratable interest, that which represented his then investment, leaving him no richer or poorer than he was before the dissolution. *Cf. William S. Gordon, Trustee*, 33 B.T.A. 460, 464; *J. Henry Dick Estate*, 20 B.T.A. 637. Such result, of course, does not obtain where the partnership is a business syndicate beyond the direct control of the individual members. *William S. Gordon, Trustee, supra.* Nor, in a case where a partner sells his interest to another, or retires from the partnership, upon an agreed consideration and the business is continued. In such cases, title to the retiring partner's interest passes to another, and a closed transaction takes place. *Hill* v. *Commissioner*, 38 Fed.(2d) 165; *Pope* v. *Commissioner*, 39 Fed.(2d) 420.

The distinction between the transaction at bar and the cases just cited by us is obvious and clear. What the decedent received in the distribution was not a consideration in exchange for his investment in the partnership fund, but his aliquot part, in kind, of the assets comprising such fund which theretofore he and his partners owned and held at risk in the business. Obviously, there was no disposition of partnership interest or of the interest of decedent in the partnership fund in this case and the provision of the regulation aptly applied to the transaction.

The petitioner's contention that the challenged provision denies to them the benefit of loss deductions otherwise allowable under the revenue acts is unwarranted by the facts. The petitioners assume that a loss must be conceded, because the stipulation shows that the market value of the assets distributed to decedent was less than his contributions to the partnership's capital plus his part of its undisbursed income. This assumption is erroneous. As hereinbefore pointed out, the assets received by the decedent on dissolution of the partnership represented his part in an investment which still exists. The fact that the investment was made through the medium of a partnership did not change its character, and the provision of the regulation, *supra,* which postpones realization of gain or loss until the assets are sold is obviously made to preserve such character.

The petitioners cite certain court and Board decisions which they contend support their theory that the distribution here considered must be given the effect of a sale or exchange in which a transfer of title to an interest in the assets disbursed took place. Among the cases cited in support of such theory are the Board cases of *Edward B. Archbald*, 27 B.T.A. 837; affd., 70 Fed.(2d) 720; *Carroll E. Donner et al., Executors*, 32 B.T.A. 364, and *Cyrus S. Eaton*, 37 B.T.A. 715; and Federal court cases, *Chisholm* v. *Commissioner*, 79 Fed.(2d) 14; and *Helvering* v. *Walbridge, supra.*

In our opinion, none of the cases so cited support the contentions petitioners here make. Rather, we think, if applicable to any phase of this controversy, the cases, in so far as they throw light, support the respondent's theory that the bare distribution of partnership assets "in kind" upon dissolution is not such a liquidation of the partner's interest as to bring into realization gain or loss to the partner. The cases cited do not deal with dissolved partnerships, or the direct question here involved. They do deal, however, with questions involving the taxability to partners, as individuals, of the increments or values by which assets contributed to the partnership capital may have increased over their initial cost of the partner.

On the latter question, the cases cited concur in holding that no gain results to the contributing partner for the increment to assets contributed in kind to the partnership until the partnership is dissolved because, until then, there is no liquidation of the assets whereby such increment can be realized as gain. Moreover, the cases hold that the ownership of partnership assets, at all times, is in the members; from which it follows that, when the assets are distributed "in kind," rather than being liquidated through sale and the cash disbursed, the partner receives, individually, his interest or part of that property which he theretofore already owned, although collectively or jointly with his copartners. If the corpus of the partnership is first reduced to cash, and the cash distributed to the member, then, of course, gain or loss may be realized as provided for in like cases of sales of property. We find no conflict in the decisions cited and the views we have herein expressed. We think the provision in the regulation challenged is in harmony with the law and we therefore sustain the respondent's interpretation.

In view of our findings, we hold that the decedent suffered no loss in the taxable year for which petitioners are now entitled to take additional income tax deductions, and their claim of overpayment of taxes is, therefore, not sustained. The result of our findings makes unnecessary our consideration of respondent's alternative prayer for readjustment of charitable deductions.

Note

1. The theory of the old regulation and of this case has been in general carried over by § 731(a), but some modifications have been introduced.

Under § 731(a)(2), loss is ordinarily not recognized until the property received on the liquidation is sold. But if the distribution is entirely of cash, unrealized receivables, or inventory (or a combination of these items), loss will be recognized. Thus if the partner, in liquidation of an interest that has an adjusted basis of \$10,000, receives \$3,000 in cash, and unrealized receivables and inventory with an adjusted basis to the firm of \$5,000, the partner will have a loss of \$2,000 regardless of the value of the receivables and inventory. This is because his adjusted basis for his partnership interest (\$10,000) exceeds by \$2,000 the sum of the money received (\$3,000) and his adjusted basis, determined under §§ 732(b) and (c), of the receivables and inventory (\$5,000). Why is the basis to the distributee partner of the inventory and receivables deliberately kept down to the firm's basis therefor, even though doing so gives him an immediate loss on the liquidation? Note § 735(a) and the second sentence of § 731(a).

2. If the partner's gain or loss is not recognized at the time of liquidation, it is necessary to allocate his adjusted basis for his partnership interest among the various assets received by him. Note that §§ 732(b) and (c) will never countenance a stepped-up basis for unrealized receivables and inventory.

FORD v. COMMISSIONER
Tax Court of the U.S., 1946
6 T.C. 499

LEECH, Judge: These consolidated proceedings involve deficiences in income taxes for the year 1941 in the respective amounts of $1,187.78 and $1,484.73. By amended petitions filed at the hearing, petitioners in Docket No. 3947 claim overpayment of income taxes in the amount of $3,137.93 and in Docket No. 3948, in the amount of $1,901.23. The issues are: (1) Whether the cost basis of partnership assets should be adjusted upon the purchase of the interest of a withdrawing partner . . . The pertinent facts were stipulated and are so found.

The petitioners in each docket are husband and wife, residing in Minneapolis, Minnesota. Joint income tax returns for the taxable period involved were filed with the collector of internal revenue for the district of Minnesota.

On December 29, 1932, petitioners, together with Sara C. Ford, executed a written partnership agreement under the firm name of "The Luther Ford Investment Company." The activities of the partnership consisted primarily of purchasing, holding and selling securities. The share interests of the respective partners, as shown by the book, were as follows.

Sara C. Ford	9/27
Allyn K. Ford	6/27
Robert E. Ford	4/27
Lina Y. Ford	4/27
Emily B. Ford	4/27

On November 26, 1938, petitioners offered in writing to purchase, as individuals, for cash the 9/27 interest in the partnership of Sara C. Ford, for a total consideration of $134,738.69. Each was to contribute towards the purchase price an amount in proportion to his or her interest in the partnership. It was further provided that the remaining partners were to continue the business uninterrupted in the same name. On the same day Sara C. Ford duly accepted such offer. Appropriate entries to reflect the transaction were made on the partnership books. The partnership was continued in the same business under the same name without interruption. In December 1941, the partnership sold certain of its securities at a considerable loss. . . . In determining the deficiences, respondent allowed two-thirds of the partnership's original cost plus one-third of the market value of all such securities as of November 26, 1938, the date of the purchase of the interest in the partnership of Sara C. Ford. It is respondent's position that each partner owns an undivided interest in each separate asset of the partnership and that when the retiring partner sells his interest to the remaining partners there is a purchase and sale of a specific asset. In support of his position reliance is placed upon the rationale of *Henry V. B. Smith*, 5 T.C. 323; *City Bank-Farmers Trust Co.* v. *United States*, 47 Fed. Supp. 98; and *George H. Thornley*, 2 T.C. 220. The respondent urges us to reaffirm our decision in the latter case, notwithstanding its reversal by the Circuit Court of Appeals for the Third Circuit, 147 Fed.(2d) 416. Those cases, however, involved the tax liability of a retiring partner. The issue here is the cost basis of capital assets of the partnership.

The courts have repeatedly recognized a partnership as a unit for computing the

income tax liabilities of the individual members. *Edward B. Archbald*, 27 B.T.A. 837; affd., 70 Fed.(2d) 720; certiorari denied, 293 U.S. 594; *Alpin W. Cameron*, 20 B.T.A. 305; affd., 56 Fed.(2d) 1021; *Helvering* v. *Walbridge*, 70 Fed.(2d) 683; and *Henry W. Healy*, 18 B.T.A. 27. The respondent would have us abandon this well established concept. Unless the partnership was dissolved by the withdrawal of Sara C. Ford, respondent's theory, as we understand it, is that the partnership is not a juristic entity, even for income tax computing purposes, but is an association of individuals each of whom owns an undivided interest in each specific asset. We think such argument ignores the fact that Congress has regarded the partnership as a separate unit for computing income taxes. Thus, when a capital asset is acquired or disposed of, the gain or loss is that of the computing unit and not the individual partners. In the instant case four of the partners purchased the interest in the partnership from the other partner. The partnership, as such, engaged in no transaction affecting it as a computing unit. It continued after the withdrawal of the partner in the same business, under the same name, without interruption, as agreed. Realistically speaking, the only change that has taken place is that the remaining partners have acquired a greater interest in the profits and surplus when final liquidation occurs. After that transaction occurred, the partnership had the same identical assets as before. The partnership as a computing unit had neither disposed of any of its old assets nor acquired any new assets. Hence, there exists no logical reason for disturbing the cost basis to the partnership of specific partnership assets. The respondent suggests that the withdrawal of the partner whose interest was purchased on November 26, 1938, constituted a dissolution or termination of the partnership and the commencement of a new partnership. By the general rule of law, death or withdrawal of a partner dissolves the partnership, but it is competent for the parties to provide otherwise. As stated by Rowley in his work on Modern Law of Partnership (sec. 550):

> . . . Whatever in the absence of express agreement of all partners may be the technical effect of the admission of a new member or retirement of an old member these conditions are ordinarily cared for by agreement, either under provisions in partnership articles authorizing a retirement, or arrangements made by the partners at the time of retirement. . . .

Cf. Burwell v. *Mandeville's Executors*, 2 How. 560, 576.

In the instant proceeding, the offer to purchase the partnership interest specifically provided for the continuation of the partnership without interruption. The partners having legally contracted for the continuation of the partnership and having actually continued it, those facts should be recognized and effect thereto given, unless prohibited by some provision of the taxing act. We are not aware of any such prohibition. Moreover, under section 27 of the Uniform Partnership Act, which has been adopted by the State of Minnesota, it is specifically provided that a transfer of a partnership interest does not of itself dissolve the partnership.

The respondent has allowed two-thirds of the original cost, plus one-third of the fair market value of the securities sold as of November 26, 1938, when the retiring partner sold her interest, as the cost basis to the remaining partners. We think he erred. Since there was no dissolution or termination of the partnership in fact or by operation of law, we conclude that with respect to those securities sold by the partnership the original cost basis to the partnership of such securities is the proper cost basis for determining gain or loss to the partnership and the individual partners, petitioners herein. . . .

Note

Assume *A*, *B*, and *C*, each put up $10,000 to form a partnership. The $30,000 is invested by the firm in securities and, at a time when the securities are worth $75,000, *A* buys out *C* for $25,000. The *Ford* case holds that on a sale of the securities by the firm, *A* has $30,000 and *B* $15,000 of gain. This result can be justified as to *B*, who has invested $10,000 and now owns a one-third interest in $75,000. But *A* has invested $35,000 and has a two-thirds interest in $75,000. How can his taxable gain of $30,000 be reconciled with the fact that he has had an economic gain of only $15,000?

The result in the *Ford* case is endorsed by the 1954 Code· § 743(a). But § 743(b) permits the partnership to elect to adjust the basis of the partnership property "with respect to the transferee partner only." What would be the effect of such an election on the *Ford* transaction? A similar adjustment to basis is authorized in the case of the death of a partner. Before 1954, although the value of the deceased partner's interest at the date of his death was included in his estate in calculating the estate tax, the basis of the property of the firm was not adjusted, so that income was realized by the estate or the heir upon a subsequent sale of the property by the firm at its estate tax value. *First National Bank of Mobile* v. *Commissioner*, 183 F.2d 172 (5th Cir. 1950).

SWIREN v. COMMISSIONER

U. S. Court of Appeals, Seventh Circuit, 1950
183 F 2d 656, cert. den 340 U.S. 912 (1951)

Before MAJOR, Chief Judge, and KERNER and DUFFY, Circuit Judges.

DUFFY, Circuit Judge.

This is a petition to review and set aside a decision of the Tax Court which affirmed the Commissioner's determination that the gain realized by taxpayer upon the sale of a partnership interest was taxable as ordinary income rather than gain on the sale of a capital asset.

Taxpayer is an attorney at law who was admitted to practice in Illinois in 1927. His first place of employment was with the law firm of Levinson, Becker, Frank, Glenn and Barnes. The firm was nationally known, and the members thereof were of prominence in the legal profession. One became a U. S. Circuit Judge, another a U. S. District Judge, and another a U. S. Senator. Mr. Levinson, the author of the Kellog Peace Pact, was very prominent in corporate financing and reorganization matters. Since 1912 the names of Levinson, Becker had been the first two names in the law firm.

On January 1, 1932, Mr. Becker purchased the interests of Levinson, Glenn and Schwartz. Levinson retained an office with the firm and for two or three years thereafter was paid an annual salary of $15,000, and for four years thereafter $9,000 annually, and he in turn permitted the firm to retain his name. Becker fixed the value of the firm at $100,000 although this sum was substantially greater than the aggregate of all of the assets of the firm, including accounts receivable and accrued but uncollected fees. Taxpayer on January 1, 1932, purchased from Becker a 10% interest in the firm and paid $10,000 therefor. The firm was thereafter known as Levinson, Becker, Gilbert, Peebles and Swiren.

In 1934, Gilbert withdrew from the firm and taxpayer purchased another 10% interest, paying $14,750 therefor. Again the amount paid was substantially in excess of 10% of the aggregate of all the physical assets, the accounts receivable and the fees earned but unpaid. Thereafter taxpayer made purchases from other

partners of portions of their capital interest in the partnership until by 1944 he had a 30% interest for an aggregate cash investment of $33,500. During the same period taxpayer had received a partial return (amounting to $14,897.74) of his total cash investment. When taxpayer sold his interest in the partnership in October, 1944, his net capital investment amounted to $18,602.26.

A short time prior to the dissolution of the partnership taxpayer prepared a statement setting forth his idea of the value of his partnership interest and the value of the partnership assets. The eight items listed totaled $151,021. Two of these items were "billed fees (excluding entirely all fees billed prior to January 1, 1944), $12,800" and "unbilled fees (exclusive of Midland), $106,093." After deducting a junior partnership share, the balance shown on the statement was $145,621, and taxpayer's 30% interest amounted to $43,686.30.

Taxpayer negotiated exclusively with Becker, telling him he believed his interest in the partnership was worth $45,000 to $50,000. No discussion was had as to the value of any of the items appearing in the memorandum. Several days later Becker offered taxpayer $40,000 for his interest, which offer was accepted. In addition to the cash consideration taxpayer received some office equipment having a book value of $506.18.

The written agreement for the sale of taxpayer's interest in the partnership was executed on December 13, 1944. Taxpayer sold and assigned "all of his . . . share and interest in the Firm, excepting only and excluding the Midland fee." [1] The agreement recited,

> Max Swiren's share and interest in the Firm sold and assigned hereby shall include his share and interest in the name and good will of the Firm, all furniture, fixtures, library, cash, fees earned whether or not billed, and accounts receivable, excluding, however, the Midland fee.

It was also agreed that as a basis for accounting the partnership be terminated as at October 31, 1944, and that the partners participate in income and expenses up to that date.

Taxpayer prepared his income tax return for the year 1944 on a cash receipts basis, and reported therein as ordinary income the fees of $29,917.26 he had received from the partnership during that calendar year. However, he listed the sum which he received from the sale of his partnership interest as a capital gain and did not include it among the figures comprising his ordinary income.

The Tax Court, adopting the Commissioner's determination, recognized that taxpayer had a proprietorship interest in the partnership, and permitted him to recover "the full amount of his unrecovered capital outlay" in acquiring his partnership interest. However, the balance of the money received by taxpayer for the sale of his interest in the partnership was taxed to him as ordinary income. This was despite the fact that he sold his partnership interest as a whole.

When the Commissioner made his determination in this case the persistent view of the Bureau had been that the sale of a partnership interest was a sale of the selling partner's interest in each specific partnership asset. However, later acknowledging that "the overwhelming weight of authority is contrary to the

[1] Taxpayer had been appointed as attorney for the trustee of Midland United Company, then in reorganization, upon the express direction of the court that he personally and not his law firm act as such attorney. As any award of fees would be and was made to taxpayer personally, such fees were regarded as a special item and not a firm asset. No issue was raised either by the Commissioner or the Tax Court with respect to the tax treatment of this item.

position heretofore taken by the Bureau" the general counsel announced on May 15, 1950,

> . . . the sale of a partnership interest should be treated as the sale of a capital asset under the provisions of section 117 of the Internal Revenue Code. The application of this rule should, of course, be limited to those cases in which the transaction in substance and effect, as distinguished from form and appearance, is essentially the sale of a partnership interest.

There is an inconsistency between the opinion of the Tax Court in the instant case and its opinions in several other cases. The Tax Court has held generally, in situations involving similar or analogous facts, that the sale of a partnership interest constitutes the sale of a capital asset. *Estate of Jones* v. *Commissioner,* 3 T.C.M. 97; *H. R. Smith* v. *Commissioner,* 10 T.C. 398, affirmed 5 Cir., 173 F.2d 470, certiorari denied 338 U.S. 818, 70 S. Ct. 61; *Long* v. *Commissioner,* 6 T.C.M. 614, affirmed 5 Cir., 173 F.2d 471, certiorari denied 338 U.S. 818, 70 S. Ct. 61; *Estate of Nitto* v. *Commissioner,* 13 T.C. 858.

Discussion of these cases except the last cited is not deemed necessary. *Estate of Nitto* v. *Commissioner, supra,* was decided after the decision in the instant case and was reviewed by the entire court. In that case the decedent was a partner in a firm which operated slot machines. He had paid $10,000 for his partnership interest and some years later sold his interest for $20,000. The profit on the transaction had been reported as a long-term capital gain. The Commissioner contended that the gain constituted ordinary income, taxable in full. The Commissioner's contention was rejected by the Tax Court which held that "the sale of a partnership interest is the sale of a capital asset, and any gain realizable therefrom is property reportable as capital gain."

Although we have considered the additional authorities relied upon by taxpayer, . . . which we regard as conclusively resolving the question involved in taxpayer's favor, it is sufficient to make reference to *United States* v. *Shapiro,* 8 Cir., 178 F.2d page 460, where all points advanced by the Commissioner against the taxpayer were held to be unsound as "contrary to the overwhelming weight of authority."

From that case (*United States* v. *Shapiro,* 8 Cir., *supra*) we quote as noteworthy this language from Judge Sanborn's opinion, 178 F.2d page 461:

> The denial, on October 10, 1949, of the petitions for certiorari in the cases of *Commissioner of Internal Revenue* v. *Smith,* 5 Cir., 173 F.2d 470, and *Long* v. *Commissioner,* 5 Cir., 173 F.2d 471, indicates to us that the Supreme Court is not disposed to disturb the rulings of the Courts of Appeals of the Second, Third, Fifth, and Sixth Circuits and of the Tax Court to the effect that the sale of an interest in a partnership is the sale of a capital asset, regardless of the nature of the partnership properties. Uniformity in the construction of tax laws is important. The District Court was entirely justified in entering judgment for the taxpayer.

In this connection we have given due weight to the factor that under Illinois law a partnership interest, such as taxpayer sold, is property distinct and separate from the partnership or underlying assets. Ill.Rev.Stat. (1949), c. 106½, Ill. Uniform Partnership Act, Secs. 24, 25 and 26. For example, Sec. 26 of the act provides: "Interest of partner. A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."

These plain statutory provisions were given effect in *Lindley* v. *Murphy,* 387 Ill. 506, 56 N.E.2d 832, and *Leuth* v. *Goodknecht,* 345 Ill. 197, 177 N.E. 690,

79 A.L.R. 780. In the *Lindley* case the court said, 387 Ill. page 514, 56 N.E.2d page 836:

The second property right of a partner is his interest in the partnership, namely, his interest in the partnership as a business or going concern. This interest, as declared in section 26, is his share of the profits and surplus and is personal property, regardless of the character of the partnership property.

The Commissioner here attempts to segregate partnership accounts receivable and unbilled fees for work in process and arbitrarily label both past earnings. The Commissioner argues that fees billed but uncollected, together with potential fees for work in process but not ready for billing or collection were taxpayer's "distributive share of partnership earnings" and therefore not a part of his partnership interest. We cannot agree.

When taxpayer purchased his interest in the firm he became entitled to his proportionate share of all fees collected by such partnership, and a portion of such fees had on the date of his purchase been billed but uncollected and other fees were for work then in process. Such fees when collected were ordinary income and those receiving them, including taxpayer, paid a tax thereon for ordinary income.

Taxpayer was on a cash receipts basis, as was the partnership. Uncollected fees for work in process not yet completed had not been transformed on the date of taxpayer's sale of his interest into gross income within the meaning of Sec. 183(b)(2), Internal Revenue Code.

In various of the cases heretofore cited listed among the partnership assets were such items as accounts receivable, rents receivable and unfinished work which in due course would yield gross income to the partnership. Nevertheless the various Court of Appeals and also the Tax Court treated the partnership interest as a whole, without regard to the nature of the underlying assets, and held the interest to be a capital asset.

We have examined and carefully considered the cases cited by the Tax Court. One of them, *Helvering* v. *Smith*, 2 Cir., 90 F.2d 590, appears to have been overruled in *McClellan* v. *Commissioner*, 2 Cir., 117 F.2d 988, and *Williams* v. *McGowan*, 2 Cir., 152 F.2d 570, 162 A.L.R. 1036. Other cases cited we regard inapplicable to the facts in this case.

The Commissioner and the Tax Court, while correct in part in regarding as a capital asset taxpayer's unrecovered net investment and allowing recovery therefor in full amount, failed to recognize that, as a matter of law, taxpayer's partnership interest as a whole was a capital asset within Sec. 117 of the Internal Revenue Code, with the gain attending the sale thereof taxable as a capital gain, and not otherwise.

The decision of the Tax Court is reversed and the case remanded to it for further proceedings consistent with this opinion.

KERNER, Circuit Judge, *dissenting.*

. . . It cannot be gainsaid that fees earned for services performed constitute ordinary income, and that upon petitioner's withdrawal from the partnership, he had the right to receive his distributive share of the uncollected fees, or past earnings, of the partnership. Had he remained a partner, his share of the fees would have been taxable as ordinary income to him when collected. *Helvering* v. *Smith*, 2 Cir., 90 F.2d 590, and *Doyle* v. *Commissioner*, 4 Cir., 102 F.2d 86. Com-

pare *Helvering* v. *Horst,* 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655; *Helvering* v. *Eubank,* 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81; and *Austin* v. *Commissioner,* 6 Cir., 161 F.2d 666. The courts have said that the sale of a right to receive ordinary income is not the sale of a capital asset. This is so even if the sale is of something which may be termed "property." In such a situation the sale price simply replaces the future income, but the sale price does not convert the ordinary income into capital gain. *Hort* v. *Commissioner,* 313 U.S. 28, 61 S. Ct. 757, 85 L. Ed. 1168. The rule is illustrated by a decision holding that when a dividend on corporate stock has been declared, a sale of the dividend rights prior to the time the dividend is payable results in ordinary income and not capital gain. *Rhodes' Estate* v. *Commissioner,* 6 Cir., 131 F.2d 50.

I have not been convinced that petitioner's share of the uncollected fees was a part of his proprietary interest in the partnership, hence I cannot say that the finding and conclusion of the Tax Court is clearly erroneous. On the contrary, I believe the evidence adequately supports the finding that petitioner upon his withdrawal from the partnership received an amount which covered both his proprietary interest and his interest in the uncollected fees, that is, capital gain and ordinary income, and since the Tax Court made an allocation between the two which is not questioned by petitioner, I would affirm the decision.

Note

1. An interest in a partnership continues to be a capital asset under § 741 of the 1954 Code. Under § 751, however, that part of the sales price attributable to the firm's unrealized receivables and substantially appreciated inventory items (broadly defined) is treated as the proceeds of a sale of non-capital assets Even under pre-1954 law, there were instances in which a "sale" of a partnership interest was not given effect as such because the only assets of the firm were accounts receivable. *Helvering* v. *Smith,* 90 F.2d 590 (2d Cir. 1937); *Trousdale* v. *Commissioner,* 16 T.C. 1056 (1951). The treatment of substantially appreciated inventory items under § 751 means that the "collapsible partnership" cannot be used as a substitute for the "collapsible corporation," now outlawed by § 341, *supra,* p. 492. See also § 732(d); S. Rept. pp. 392-3; and § 708(b)(1)(B). Previously it had been thought by some practitioners that partners could dispose of appreciated property held by a partnership at the capital gain rate by selling their interests in the firm instead of allowing the firm to sell the underlying property.

The term "unrealized receivables" is defined by § 751(c) to include "any rights (contractual or otherwise) to payment for . . . services rendered, or to be rendered," if not already taken into income. In the case of a law firm, would this definition include the value of work already completed if the firm's fee is dependent upon the outcome of litigation or is discretionary with a court?

2. Where payments are made "in liquidation of the interest" of a retiring or deceased partner, somewhat different principles come into play, as a result of § 736. This aspect of the *Swiren* case is considered *infra,* p. 628.

CARTER v. COMMISSIONER

Board of Tax Appeals, 1937

36 B.T.A. 60

HILL: Petitioners allege that respondent, in determining the deficiencies, erred in treating as distributable income of the partnership [a law firm] and including in taxable income of each of the petitioners, other than the estate of Robert Burkham,

deceased, their respective proportionate interests in the amount paid to the estate of decedent during the taxable year, pursuant to the partnership agreement of January 1, 1927. Substantially, the position of the petitioners is that the sum paid to the deceased partner's estate was that portion of the income from fees received by the partnership which was due the decedent's estate, and was received by the partnership as trustee for such estate.

The facts were stipulated by the parties, and on this issue, among other things, it is stated that neither of the petitioners nor any members then constituting the co-partnership

received any part of the sum . . . paid to the estate of Robert Burkham, deceased, but pursuant to the terms of the agreement of January 1, 1927 herein referred to, said sum was received by the co-partnership with the duty imposed to pay the same to the said estate of Robert Burkham, deceased, which duty was duly performed, as aforesaid.

The meaning intended to be expressed in the quoted stipulation . . . is not entirely clear, but we need not construe it. If it was meant to say that the money out of which the sum in controversy was paid to the decedent's estate was not first "received" by the partnership it is contrary to the facts otherwise clearly established by the record and must be rejected. *William Ernest Seatree*, 25 B.T.A. 396; *Volunteer State Life Insurance Co.*, 35 B.T.A. 491. If the parties intended to stipulate that the sum was received by the partnership not as its own property but in trust for the estate of the deceased member, then the stipulation amounts to a legal conclusion and must be disregarded. Unless the fund when received belonged to the partnership, obviously it could not constitute distributable income taxable to the members. This involves the very question which has been submitted to the board for decision. "A stipulation concerning the legal effect of admitted facts is ineffective, and will be treated as a nullity." *Swift & Co.* v. *Hocking Valley Railway Co.*, 243 U.S. 281, 280. If the parties meant to stipulate that the fund was not actually distributed to the members, it is of no materiality. In any event, therefore, it will be disregarded.

It is conceded by all parties that the death of Robert Burkham dissolved the old partnership, and that the new partnership organized by the surviving members paid the amount in controversy to the decedent member's estate under and pursuant to the terms of the partnership agreement of January 1, 1927; also that the principal purpose of the agreement was to eliminate a partnership administration upon the death of a partner and an accounting over a long period of time by the surviving partners.

Solution of the problem presented here depends upon whether the sum paid to Burkham's estate represented his share of fees earned by the partnership prior to but uncollected at the time of his death, or whether such payments constituted the consideration paid by the surviving members for Burkham's interest in the old partnership and its assets. *Bull* v. *United States*, 295 U.S. 247.

The nature of the transaction, we think, is fully disclosed by the terms of the partnership agreement pursuant to which it was carried out, which provided that in the event of death of any member of the firm his heirs, executors, or administrators should receive a sum equal to one-half of the amount actually received by such deceased partner during the two calendar years next preceding such death

in lieu of all interest which the heirs, executors or administrators of such deceased partner may have in any fees received by the firm subsequent to the date of such

death . . . and in full payment of the interest of such deceased partner in the library and office equipment of the firm.

The partnership agreement further recited that,

each member of the firm hereby agrees in the event of his death that no administration of the firm or its assets shall be required, and waives all right thereto and agrees that the payment made to his heirs, executors or administrators as above provided, shall be taken and received by them in full payment for his interest in the firm and its assets.

The conclusion seems inescapable to us that by the payment of a definitely ascertainable consideration, which is the amount here in controversy, the surviving partners of the old partnership purchased all of the interest of the deceased Burkham in the firm and its assets. The parties have stipulated that one of the purposes of the partnership agreement was to fix at death a definite sum for payment to the estate of a deceased member, regardless of whether, in the absence of such agreement, the amount payable to the deceased partner's estate for his interest in the partnership would have been greater or less than the amount fixed by the agreement.

Whether the interest of the deceased Burkham had in fact a fair value of more or less than the amount paid under the contract, and whether or not the survivors derived a profit from their purchase of his interest for such sum, does not appear from the record. No question is raised on this point. Likewise, it does not appear what assets, if any, the partnership owned other than a library and office equipment of undisclosed value. The petitioners offered no evidence as to these matters. But in the state of the record before us, they are in any event immaterial.

The fact remains that the surviving partners purchased the interest of Burkham in the firm and its assets, for a stated consideration. Thereupon, they became the exclusive owners of all uncollected fees, whether the services for the rendition of which such fees were received were performed either prior or subsequent to his death. It was out of such fees that the amount in question was paid to Burkham's estate. The amount, therefore, constituted distributive income of the new partnership when received, and is taxable to the petitioners to the extent of their respective interests, whether in fact distributed to them or not.

The partnership did not act in a fiduciary capacity in respect of any of the fees collected after the death of Burkham. His estate had no interest therein. Under the partnership contract it had only the right to demand payment of the stipulated amount. It was not entitled to payment out of fees, and in case no fees had been collected within the time fixed for payment, the estate would still have been entitled to receive the amount agreed upon, and the partnership could have fully discharged its obligation by payment out of any fund, whether or not it embraced fees collected subsequent to Burkham's death.

In *Willard C. Hill,* 14 B.T.A. 572, a partnership was formed under an agreement which provided, among other things, that upon the death of any partner there should be paid to his estate for a period of years the share of partnership earnings to which the deceased partner would have been otherwise entitled, and that upon the completion of such payments the business should become the sole property of the surviving partners. We held that the partnership agreement provided for the sale of the interest of a deceased partner to the surviving partners, and that there should be included in the net income of each surviving partner his distributive share

of all amounts paid in accordance with the terms of the partnership agreement, to the estate of the deceased partner. In that connection we said:

> A partner may not avoid the income tax under an agreement by which his share or a portion of his share of the profits of the partnership are to be paid to the estate of a deceased partner in the acquiring of such deceased partner's interest in the assets of a prior partnership.

Our decision in the cited case was affirmed in *Hill* v. *Commissioner*, 38 Fed.(2d) 165. See also *Benedict* v. *Price*, 38 Fed.(2d) 309; *Pope* v. *Commissioner*, 39 Fed.(2d) 420; *Arthur C. Hilmer*, 27 B.T.A. 1165, *cf. Lester G. Hathaway*, 16 B.T.A. 1318.

In *Bull* v. *United States*, *supra*, the Supreme Court stated the applicable rule as follows:

> Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon the firm profits and the estate is not [citing with approval *Hill* v. *Commissioner*, *supra*].

For the reasons indicated respondent's determination in respect of the first issue is approved.

The conclusions reached above are not in conflict with our decision in *Gussie K. Barth*, 35 B.T.A. 546. The latter case is distinguishable on the facts. There the partnership contract provided that "the partnership shall not be immediately dissolved by reason of the death of a partner but his interest therein shall be determined" by payments to his widow for a period of three years of specified percentages of what would have been the deceased partner's distributive share in the proceeds from the business if he had remained alive. The amount received by Barth's widow did not represent payment for capital assets. In the instant case, the old partnership owned tangible assets and the amount paid to the decedent's estate was for his interest in the old partnership, including such assets.

Furthermore, in the *Barth* case, the question presented was whether the amount paid by the surviving partner constituted income taxable to the widow of the deceased partner. Here the question is whether the amount paid to the decedent's estate by the surviving partners, having been paid out of income (that is, out of fees collected by them), constituted distributive income taxable to the members of the new or succeeding partnership. Since the transaction before us was clearly a purchase and sale of the deceased partner's "interest in the old partnership and its assets," the consideration paid by the new partnership out of income is taxable to the members of that partnership, whether or not the consideration so paid also represents *in whole or in part* taxable profit to the decedent's estate. In no event, therefore, does the *Barth* case rule the decision in the instant case.

HALL v. COMMISSIONER

Tax Court of the U.S., 1952
19 T.C. 445

TIETJENS, Judge: The partnership of Touche, Niven & Company paid certain amounts during its fiscal year ended September 30, 1947 to Whitworth, Clowes,

and the estate of Victor E. Stempf. The sole issue is whether $48,668.26 of these amounts was paid as part of the purchase price of the interests of these former partners, or as a distribution of profits, as income, to the retired partners and the estate.

If the payments in controversy were paid as part of the purchase price of the interests of the former partners, they would not be deductible in computing the distributable income of the partnership taxable to the continuing partners, of whom Carol F. Hall is one, and, accordingly, in the hands of the retired partners, Whitworth and Clowes, the payments would be properly treated as capital gains. This is the position taken by the respondent in this proceeding, and by the retired partners in their related proceedings. On the other hand, if the payments represented distributions of firm income to the retired partners and the estate of the deceased partner, they would not be includible in the profits taxable to the continuing partners and would be taxable as ordinary income to the retired partners. This is the position of these petitioners and is also the position taken by respondent in the related cases of Whitworth and Clowes.

The payments in controversy were part of a total of $288,433.26 which the administrative partners had agreed to pay Whitworth, Clowes, and the estate of Stempf under the partnership agreement of 1936, which was in effect at the times Whitworth and Clowes retired and Stempf died. This agreement provided that the death or retirement of a partner should not dissolve the partnership between the remaining partners and required the continuing partners to make certain payments to the retired partners or estates of deceased partners. The continuing partners were required by Article XI, section 1, to repay any loan made the firm by the former partner, as well as his current account balance and his share of the past distributable profits. His paid-up participation in the stated capital was to be repaid in installments with interest. Article XI, section 2,* pro-

* Section 2. If any partner shall retire pursuant to Section 2 of Article X hereof after attaining the age of sixty-five years or shall die at any age, there shall be payable, in addition to the amounts hereinbefore provided in paragraphs (a), (b) and (c) of Section 1 of this Article XI, to such retiring partner, or to the personal representatives of such deceased partner, out of distributable profits, such amount as may be determined by the decision of a majority in interest of the Administrative partners but in no event less than the smaller of the following

(a) an amount equal to three (3) times the annual average of the sum of the salary plus the distributable profits of the partnership which such deceased or retiring partner received or was entitled to receive in respect of the business of the partnership carried on during the ten (10) fiscal years of the partnership next preceding the fiscal year in which such partner died or retired; or

(b) an amount equal to the sum of the salary plus the distributable profits of the partnership to which such deceased or retiring partner would have been entitled, if he had not died or retired and if his ratio in the profits of the partnership had not been altered, in respect of the business of the partnership carried on during the three (3) succeeding fiscal years of the partnership, including the fiscal year in which such partner died or retired, but for the purposes of this subdivision (b) the distributable profits shall be determined after deducting current salaries and current interest on capital of any additional partners as well as those of the surviving or continuing partners.

The amount so determined to be payable shall be payable, without interest, in six (6) equal annual instalments, the first of which shall become payable at the expiration of one (1) year from the date of death or retirement or at such earlier date as a majority in interest of the Administrative partners may determine, but, unless the distributable profits then available shall not be sufficient, no annual instalment payment during each of the first three (3) years after such death or retirement shall be less than fifty per cent (50%) of the annual salary of such

vided that in case of the death of a partner, or his retirement at age 65 there was to be paid, in addition, an amount to be fixed by the administrative partners, which amount was to be measured by the former partner's share in earnings in past years or the share he would have had in the next 3 years' profits had he continued as a partner; it was to be paid out of distributable profits in installments over a period of 6 years; and the agreement stated the payment "is intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death." In section 3 of Article XI, authority was given the administrative partners to pay such sum as they might deem advisable in the case of any partner retiring before reaching age 65, or withdrawing for any other reason.

The solution of the question depends upon the intent of the parties and that is to be derived from the 1936 partnership agreement. Despite contrary arguments, we think the payments here involved were made pursuant to section 2 of Article XI of that agreement and, accordingly, are controlled by that section. . . .

The payments, being made pursuant to section 2, are subject to certain other provisions of that section. They were to be made "out of distributable profits" and they were "intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death." Also, it was provided that no annual installment in the first 3 years should be less than 50 per cent of the partner's annual salary at death or retirement or less than $5,000, "unless the distributable profits shall not be sufficient." Thus the payments were keyed to the existence of profits, and the intent appears that a partner who retired, or the estate of a partner who died, was to continue for a time to participate in the profits on the same basis and in approximately 50 per cent of the amount as before the event. We find no language in the written agreement which would justify a conclusion that the retiring partners intended to "sell" their interest in the partnership to the continuing partners, or vice versa, that the continuing partners intended to "buy" the retiring partners' interests.

The case of *Charles F. Coates*, 7 T.C. 125, is here apposite. There are factual differences, but we do not think them significant. Respondent has acquiesced in that case, 1946-2 C. B. 2. Coates was a continuing partner in an accounting firm which provided in the partnership contract that the death of a partner should not operate to dissolve the co-partnership, that the estate should continue as a member for 5 years with no direct voice in management, that the estate should participate in the net earnings in stated proportions and not be liable for losses, that the deceased partner's "capital interest" should be settled as soon as possible, and that at the end of 5 years and the completion of the payments the interest of the deceased

deceased or retired partner at the date of his death or retirement, or less than five thousand dollars ($5,000) per annum.

The payment under this Section 2 is intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death.

The provisions for the payment to be made under this Section 2 of this Article XI are limited to the cases specifically provided for hereunder and do not apply to any partner who retires or withdraws at any other age or for any other cause.

Section 3. Notwithstanding any of the provisions of this Article XI, by decision of a majority in interest of the Administrative partners, there may be paid such sum of money in such instalments as they shall deem advisable to any partner retiring before he attains the age of sixty-five (65) years or to any other partner who may withdraw for any other reason

parties should terminate. No partner had contributed any capital and capital was not important in that personal service organization. The "capital interest" consisted of (1) the pool of undrawn earnings (the amount withdrawn having been limited to 85 per cent of each partner's share for the previous year) and (2) the value of the work then in process. We noted that since the agreement provided for the return of any remaining interest in the firm's assets it was difficult to find evidence of an intent to sell the interest of the deceased partner, that the parties placed no value upon the good will and partnership name and that ordinarily no substantial value attaches to good will of such a personal service partnership. We said further:

> In addition to the provisions for the return of the "capital interests" to the estates are the provisions with which we are here concerned for participation by the estate of a deceased partner in the earnings of the partnership for five years after the partner's death. These payments have no relation to the other type of payments provided for the liquidation of the capital account. They provide simply that the estate of any deceased partner shall participate to the extent there provided in the net earnings of the partnership for a period of five years. The evidence establishes that this provision was intended by the parties not to be the consideration paid by the surviving partners for the capital interest of a deceased partner upon the dissolution and liquidation of the partnership, but was intended to be a present consideration given by each partner upon the formation of the partnership. It was intended to be in the nature of a mutual insurance plan, the disadvantage of which each partner was willing to accept in consideration of a similar commitment for his benefit on the part of all other partners, and, in part, as further compensation for the past services of the deceased partner payable after his death.
>
> These payments were not made in liquidation of any capital interest of the deceased partner in the firm's assets. The only payments of this nature required upon the death of a partner were the payments on account of past earnings and work in process, here designated as the "capital account." In addition to these payments, the estate of a deceased partner was entitled to the payment of a share of post death earnings, not in consideration of a sale of partnership assets on liquidation, but in consideration of mutual promises contained in the original partnership agreement having no relationship to such a sale. These payments arose out of and depended upon the contract and their character must be determined by its terms. The estate acquired, upon the death of the partner, a vested contractual right to a share of the earnings, as earnings, and this right was fortified by a power lodged in the trustee to require a liquidation of the business if its rights were not fully respected by the surviving partners. When and as the income was earned, it became immediately subject to the preexisting rights of the estates to their share of it. The amounts so distributable to the estates were not distributable to any surviving partner, with the result that here, as in *Richard P. Hallowell, 2nd, supra*, the disputed amount attributed by the respondent to each surviving partner may not be regarded as "his distributive share, whether distributed or not, of the net income of the partnership."

The case of *Richard P. Hallowell, 2nd*, 39 B T.A. 50, referred to in the above quotation, is also in point. There, the agreement provided that the interest of the estate of a deceased partner should be deemed a loan and that the estate should have the same interest in profits the deceased partner would have had if living, until the termination of a period agreed upon. Since settlement of the capital interest was to be accomplished under other provisions of the agreement, we concluded that the estate shared in profits as a matter of right under the contract. See also *Sidney Hess*, 12 T.C. 773, and *cf. Estate of Boyd C. Taylor*, 17 T.C. 627.

Clowes and Whitworth, and respondent in this proceeding, rely upon certain

cases to the effect that where the partners agree that a deceased partner's interest shall be acquired by the surviving partners by payments of firm profits to his estate, there is a sale of the interest and the profits so paid are taxable to the survivors and represent the purchase price of a capital asset. See *Hill* v. *Commissioner* (C. A. 1, 1930), 38 F.2d 165, affirming 14 B.T.A. 572; *Pope* v. *Commissioner* (C. A. 1, 1930), 39 F.2d 420, affirming 14 B.T.A. 584, *W. Frank Carter*, 36 B.T.A. 60 (1937), and *Estate of Bavier C. Miller*, 38 B.T.A. 487 (1938). In these cited cases the deceased partners had made a capital investment in the partnership which was not repaid to their estates, but was transferred to the surviving partners in consideration of the payments involved. In the present case the capital investments of the deceased or retiring partners were returned to them in full pursuant to section 1(c) of Article XI. Payment of the distributable profits for the current year of retirement or death was also provided for in section 1(b) of Article XI. The payments provided for in section 2 or 3 of that Article were additional and distinct. Since they could not be a return of capital they could be only distributions of income. We think these cases are distinguishable on their facts. No sale or purchase of partnership interests was here intended. See *Bull* v. *United States*, 295 U.S. 247 (1935).

Clowes and Whitworth contend that the partnership had good will of a considerable value and working papers which were an asset in their business, that the interest of the retiring partners in these items was the subject of a sale in the transfer of their interests to the continuing partners and that the payments in controversy were intended as the purchase price of these assets. This argument is not borne out by the agreement. Article IV provides that a deceased, retiring, or withdrawing partner shall have no interest in the firm name and no right to receive any payment therefor. As to the good will, in the first place it is inextricably associated with the firm name and not transferable otherwise, and in the second place the good will of a personal service organization such as this, is rarely a vendible article. *Charles F. Coates*, *supra.* As for any good will attaching to Whitworth or Clowes individually and separate from firm good will, these retiring partners made no agreement not to compete with the firm and hence must be deemed not to have relinquished or transferred it, if indeed it could be transferable. The firm in its financial calculations at no time placed any value upon the firm name, good will, or working papers. Nor do we find anything in the agreement disclosing any intention to value good will as such or to make any payments in consideration of the sale thereof to the surviving partners.

We think that the partners in entering into the 1936 agreement, intended that a retired partner, or the estate of a deceased partner, should share in the profits of the firm, as profits, for a limited period after the event, that the provision was in the nature of a mutual insurance plan in which each partner assumed its possible burdens in consideration of the assumption of a like obligation by his partners to him, and that the payments here in controversy were properly deducted by the continuing partners in determining the distributable partnership income taxable to them.

Because of conceded adjustments,

Decision will be entered under Rule 50.

Note

1. Recognizing that "existing case law presents no consistent approach" to the tax treatment of payments to retiring or deceased partners (S. Rept. p. 97), Congress has provided § 736 as a statutory guide to this area. The *Swiren*, *Carter*, and *Hall* cases should be reexamined with § 736 in mind. Assuming a payment in cash (a payment in property presents added complications, though the basic principle is the same), § 736(b) provides for segregating the portion that is paid "in exchange for the interest of such [retiring or deceased] partner in the partnership property." This may not include any amount paid for good will, unless the partnership agreement provides for such a payment, or for unrealized receivables. The amount thus paid for the partner's capital interest cannot be deducted by the remaining partners, and to the recipient it will produce capital gain or loss depending upon whether it exceeds or is less than the adjusted basis of the partnership interest. (It is not clear whether an exception to capital gain or loss treatment will be made if part of this payment is attributable to substantially appreciated inventory. See § 751. Note that payments for unrealized receivables have already been excluded.) The rest of the payment to the retiring or deceased partner will be deductible by the remaining partners, and will be ordinary income to the recipient.

Note that "payments made in liquidation of the interest" of a retiring or deceased partner under § 736 are taxed quite differently from the proceeds of a "sale or exchange of an interest in a partnership." On a sale or exchange, the amount received will produce capital gain or loss in its entirety under § 741, except for the amount, if any, attributable under § 751 to unrealized receivables or substantially appreciated inventory items. *Supra*, p. 620. A major distinction between the two approaches lies in the treatment of a payment for good will. Such a payment will produce ordinary income under § 736, unless it is provided for in the partnership agreement, and even then the Senate Report (p. 395) states that the payment "may not exceed the reasonable value" of the partner's interest in good will. See again what is said about good will in the *Hall* case. Under §§ 741 and 751, however, a payment for good will is not taxed as ordinary income when a partnership interest is sold or exchanged.

Section 736 deals only with "payments made in liquidation of the interest" of a retiring or deceased partner, and by virtue of § 761(d) this phrase is restricted to a distribution, or a series of distributions, "to the partner *by the partnership*." Payments by others are governed by §§ 741 and 751 rather than by § 736. Note the statement in the *Carter* case that "the surviving partners of the old partnership purchased all of the interest of the deceased Burkham in the firm and its assets"; similarly in the *Hill* case, cited by the court, the partnership agreement "provided for the sale of the interest of a deceased partner to the surviving partners." The agreement in the *Swiren* case provided that the retiring partner sold his interest to the two remaining "proprietary" partners (there were also junior partners who had no proprietary interest), and it does not appear whether their respective shares in the purchase were proportionate to their interests in the firm's assets. *Swiren v. Commissioner*, ¶ 49,251 P-H Memo TC. Would the payments in these cases be governed by § 736 or by § 741? Is there a difference between selling the retiring or deceased partner's interest to the surviving partners in proportion to their respective interests in the firm, and a liquidation of the partner's interest under § 736?

Suppose the agreement provides that upon the death of a partner, his entire interest in the firm's assets and earnings shall cease, and that a "death benefit" shall be paid to his named beneficiaries in either a stated sum or in an amount measured by, or not less than, a specified percentage of the firm's previous or subsequent earnings for a stated period. Would § 736 be applicable? Would it apply to an agreement providing that upon the death of a partner, his executor may elect to continue as a partner for a limited period, receiving a stated percentage of the firm's profits, with the estate having no further claim of any kind on the firm's assets or earnings?

2. See § 743, allowing an adjustment to the basis of the partnership property, in the case of a sale or exchange of a partnership interest, or upon the death of a partner, to reflect the price paid for the ex-partner's interest in it.

Section C. Tax-Exempt Organizations

C. F. MUELLER CO. v. COMMISSIONER

Tax Court of the U. S., 1950
14 T.C. 922

MURDOCK, Judge: The Commissioner determined a deficiency of $136,438.62 in the income tax of the petitioner for the period beginning August 28 and ending December 31, 1947. The sole issue for decision is whether the petitioner is exempt from tax under section 101(6) of the Internal Revenue Code *. . . .

The petitioner was incorporated under the laws of Delaware on August 21, 1947. Its return for the taxable period was filed with the collector of internal revenue for the fifth district of New Jersey.

C. F. Mueller Co., a New Jersey corporation, hereafter referred to as the old company, took over a business established in 1867 and had been engaged since 1905 in the manufacture and sale of macaroni and similar products, all hereafter referred to as macaroni. It was a taxable business corporation, successfully engaged in commercial activities for profit in competition with other similar corporations. Henry Mueller, its president, died in November, 1946. . . .

H.T. Sorg, a person not connected with New York University, conceived the idea of acquiring all of the stock of the old company on behalf of the Law School of New York University. He made inquiries of a representative of the Muellers as to the possibility of acquiring all of the outstanding stock of the old company, and in February, 1947, discussed his idea with Arthur T. Vanderbilt, then Dean of the Law School of New York University. The university had a large enrollment, a relatively small endowment, charged students less than cost, and needed funds with which to operate.

Sorg, representing Vanderbilt, and a group of other persons interested in the law school, negotiated successfully with the stockholders of the old company for the purchase of the stock and with the Prudential Insurance Co. of America for a loan to finance the purchase.

The petitioner was incorporated in order to carry out the plan of acquiring the stock, and it acquired all 7,860 shares of the outstanding stock of the old company on August 28, 1947, at a price of $3,495,057.60, $466.66 per share, in an arm's length transaction. It financed the purchase by borrowing $3,550,000 from the Prudential Insurance Co. of America. The loan was to be repaid within 15 years. The Prudential Insurance Co. required in the loan agreement that the petitioner have the power to carry on the business, that it continue the business, and that it take over seven-year employment contracts of three employees of the old company. The loan agreement also required that 75 per cent of the income of the petitioner be used to reduce the loan to $1,500,000 and thereafter that further payments be made, and provided, in effect, that the payments or other distributions

* § 501(c)(3), 1954 Code [Ed.]

to New York University could not exceed 25 per cent of the excess of the net earnings over the net losses of the petitioner until the debt was paid.

The petitioner agreed to pay Sorg a commission of $124,250 for his services.

It is stated in the certificate of incorporation of the petitioner that it

> is organized exclusively for charitable, scientific, literary, and/or educational purposes and no part of its income or property shall inure to the private benefit of any stockholder, director, or officer, or any individual or corporation other than New York University for the exclusive benefit of its School of Law.

The directors are authorized to distribute to the university for the exclusive benefit of the law school such part of the property and net income of the petitioner as they may determine and as may be distributable legally; and the objects for which the petitioner was formed are, *inter alia,* to manufacture and sell macaroni and kindred food products. The certificate contained a detailed statement of the usual powers of a business corporation which the petitioner was to have. Those objects and powers are almost identical with those of the old company.

The petitioner and the old company entered into an agreement of merger on August 28, 1947. . . .

The above steps were all taken pursuant to a plan to acquire the business of the old company and make its income available for the use and purposes of the Law School of New York University. The form was adopted in an effort to achieve, if possible, tax exemption for the petitioner under section 101(6) of the Internal Revenue Code.

The total authorized stock of the petitioner consisted of ten shares, each of the par value of $100. All of those shares are to be held for ten years by voting trustees under a voting trust agreement dated August 28, 1947, after which they are to be transferred to New York University. The trust exists solely for voting purposes. The petitioner's capital of $1,000 was contributed by Vanderbilt, who considered it a contribution to New York University. None of the voting trustees received compensation, except one, who received $4,000 as compensation for services as president of the petitioner.

The petitioner, since August 28, 1947, has carried on the business formerly conducted by the old company, using the same plant and office facilities, the same banking facilities and the same trade-marks, and without any noteworthy change in manufacturing operations, sales policies, advertising policies, employees, or clientele. . . .

The only question for decision is whether the petitioner is exempt from tax under 101(6). The Commissioner contends that the petitioner was organized and operated for the purpose, among others, of carrying on a large, competitive, commercial business for profit, and it does not come within the exempt class merely because its earnings inure solely to the benefit of another corporation which comes within the exempt class. The petitioner, citing *Trinidad* v. *Sagrada Orden de Predicadores*, 263 U.S. 578, says the test is not the source from which income is derived, but rather the destination of the income, and, therefore, exemption is not to be denied merely because its income is derived from a commercial or business activity which it conducts profitably. It is not satisfied to be called a "feeder" of an educational corporation, but claims that it falls squarely within the exempt class. It was organized and operated exclusively for educational purposes within

the meaning of section 101(6), it argues, since, as is conceded, it was carefully organized and operated so that no part of its earnings may ever inure to the benefit of any private stockholder or individual, but all must inure solely to the benefit of the law school through the university. The word "educational," as used herein, is to be understood to include any religious, charitable, scientific, literary, or educational purpose which might in any way relate to the petitioner because no point is made as to whether the purpose be of one kind or the other.

Perhaps it might be well to discuss first the question of whether this case is ruled by the *Sagrada* case. The conclusion has been reached that neither that case nor others like it are controlling here, because each of those cases dealt with a corporation itself engaged in carrying on some religious, charitable, or educational activity, whereas the petitioner is not engaged at all in that kind of work, but is engaged in carrying on a regular commercial business as its only activity; that is, it is auxiliary to an educational institution, but is not itself such an institution. Such a marked factual difference requires a new and further examination of the intended scope of section 101(6). . . .

The Court, in the *Sagrada* case, regarded as material "the fact that the limited trading, if it can be called such, is purely incidental to the pursuit of those purposes [of the religious order], and is in no sense a distinct or external venture." It pointed out that there was no selling to the public or in competition with others, or for the mere profits involved, but only for uses purely incidental to the religious, charitable, and educational work of the religious order. That case and *Unity School of Christianity*, 4 B.T.A. 61, *Sand Springs Home*, 6 B.T.A. 198, and others which followed it, are distinguishable from the present case because the petitioner in each of those cases was primarily engaged in carrying on religious, charitable, or educational activities and was held to have retained its exempt character even though it also carried on some profitable business. *Universal Oil Products Co.* v. *Campbell*, 181 Fed. (2d) 451.

The liberal test of the ultimate destination rather than the source of the income, developed in those cases, should not be stretched and distorted to cover a different type of corporation from the one with which the courts in those cases were dealing. Here, as already pointed out, the petitioner is not the corporation engaged in operating the educational institution, but is a wholly separate corporation which has as its sole day-to-day activity the operation of a macaroni business for profit. Such use of business corporations is relatively new, born principally of the necessity for colleges to obtain more income than the return theretofore received on their funds available for investment. Formerly, it was not the custom for educational and other similar institutions to risk their funds in carrying on a competitive business for the profit in it. It is not fair to assume that the judges, in deciding those earlier cases, had in mind corporations like the present petitioner or that they were careful to say what they said with the intention that it should apply also to corporations like the petitioner which might later come into extensive use. *Osaka Shosen Line* v. *United States*, 300 U.S. 98, 103.

Most of the other cases cited by the petitioner are distinguishable on the same ground, but a few of the more recent ones involved corporations somewhat like the petitioner. The court, in *Roche's Beach, Inc.* v. *Commissioner*, 96 Fed. (2d) 776, relied upon the *Sagrada, Unity School of Christianity*, and *Sand Springs Home* cases to hold that a corporation engaged in the operation of a bathing

beach was exempt under section 101(6) though not under section 101(14) †. . . . The Commissioner's effort to distinguish the *Roche's Beach* case from the present one is not convincing, and if the two are not distinguishable, then, with all due respect, the Tax Court, not being convinced by the reasoning of the majority in the *Roche's Beach* case, declines to follow it at this time. This Court had held in that case that the corporation was not exempt. See 35 B.T.A. 1087. . . .

Do the provisions of section 101(6), when considered along with those of section 101(14), indicate that Congress intended to exempt a corporation like the petitioner, not itself engaged in educational activities, not merely holding property and collecting the income therefrom for an exempt educational institution, but actively engaged in operating a competitive, commercial business, in the operation of which it is entitled to deduct, and has actually deducted, social security taxes and, under section 23(q)(2), charitable contributions? Congress, without comment in committee reports, included a new provision in section 11(a), Twelfth, Revenue Act of 1916, exempting income received by any

> Corporation or association organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title.

A similar provision now appears as section 101(14) of the Internal Revenue Code. If the petitioner is right in its contention that it can engage actively in a big commercial business for profits and be exempt under section 101 (6) because its profits go to an exempt organization, then, *a fortiori*, any mere holding and collecting agent for a corporation exempt under 101(6) likewise would be exempt under 101(6) and, to that extent at least, there was no need for the new provision. A more logical interpretation of sections 101(6) and (14) is that Congress therein exempted two different classes of corporations—those actually engaged in charitable or educational activities and those relatively inactive corporations which merely hold title to property, collect the income therefrom, and turn it over to a corporation of the exempt class. The present petitioner does not come within either of those classes. . . .

Congress had clearly in mind the difference between the various kinds of corporations. It intended to exempt some because of the main activity carried on and others because they merely held property and collected the income therefrom for an exempt corporation. It said nothing about a third class which enters actively into business to make money for an exempt corporation. The average person would easily distinguish that class from charitable and educational institutions because it is not engaged in charitable or educational activities. Congress intended to tax all commercial corporations competing with each other for business and profits and merely allowed them, in section 23(q)(2) ‡, limited deductions for contributions made by them to charitable organizations.

Furthermore, the benefits to the public from the complete exemption of a corporation like this petitioner are not so apparent. That exemption could have a vicious effect upon nonexempt competitors because the exempt corporation, unlike the mere holding company, might be able to undersell its competitors as a result of the tax advantage and thus either drive them out of business or absorb them

† Now § 501(c)(2), 1954 Code. [Ed.]
‡ Now § 170(b)(2), 1954 Code [Ed.]

through its unlimited power to expand The Court has concluded that Congress, in using the words "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" in section 101(6), meant only organizations actually and principally engaged in an activity of the kind mentioned, and did not mean to include in the exempt class another quite different class, the principal activity of which is engaging in a competitive commercial business for profit, although those profits are ultimately destined for a corporation in the exempt class. . . .

Congress, in section 101(6), has not based the exemption solely on whether any part of the net earnings inure to the benefit of any private stockholder or individual, but has said that a corporation to be exempt must also have been "organized and operated exclusively" for the purposes mentioned. . . . The word "exclusive," referring to something other than the use to which the earnings are to be put, limits the exemption to corporations with a singleness of purpose to carry on one or more of the charitable, educational, and other activities entitling it to exemption. The Court in the *Sagrada* case had this singleness of purpose in mind. One can not say properly that a corporation was organized and operated *exclusively* for educational purposes where, as here, one of its important purposes was to conduct a large commercial business for profit, competing with other similar corporations all subject to tax, and where the operation of that business is not merely incidental to the conduct by the same corporation of any other overshadowing exempting activity. The purpose to aid the educational institution, regardless of its relative importance, is not the exclusive purpose in the organization and operation of the petitioner.

It is the opinion of this Court, in the absence of any compelling authority to the contrary, that Congress recognized the generally understood difference between corporations like the petitioner and corporations like universities, hospitals, religious orders, and churches, and did not intend to include corporations like the petitioner in the class to be exempt under section 101(6).

Reviewed by the Court.

Decision will be entered for the respondent.

[Dissenting opinion of JUDGE OPPER is omitted]

Note

1. The decision of the Tax Court was reversed by the Court of Appeals, Third Circuit, on the authority of the *Roche's Beach* case. *C. F. Mueller Co.* v. *Commissioner*, 190 F.2d 120 (3d Cir. 1951). In the meantime, however, Congress had amended the statute, explicitly denying the exemption to a "feeder" organization like the Mueller Company, though it subsequently provided that certain "feeders" (the Mueller Co. being one) would be exempt for years before 1951. This combination of judicial and legislative action would make the Tax Court's opinion little more than a footnote to history, except that New York University's macaroni business (and similar ventures by other tax-exempt organizations) played an important role in the hearings that led to the statutory changes of 1950. Moreover, the issues of policy, though temporarily laid to rest, are by no means dead.

2. Two of the 1950 amendments bear directly on the treatment of New York University's macaroni business. A "feeder" organization "operated for the primary purpose of carrying on a trade or business for profit" cannot claim the tax-exemption that attaches to its beneficiaries. See § 502, 1954 Code. (The statutory exemption

granted by § 501(c)(2) to "feeders" that are mere holding companies was left undisturbed.) This change alone would have left the door open (as did the Tax Court in the *Mueller* case) to the tax-exempt operation of businesses *directly* by the tax-exempt organizations, though perhaps for most charities the direct operation of a business enterprise would be either *ultra vires* or impractical because the safety of trust funds would be jeopardized.

Recognizing that the denial of tax-exemption to "feeders" alone would not fully accomplish its purpose, Congress went on to tax the "unrelated business income" of certain tax-exempt organizations. This category of income, new to the Code, is defined by § 512; roughly speaking, it means the income from any trade or business (not including mere investment) regularly carried on by the tax-exempt organization that is not substantially related to the performance of its charitable, educational, or similar function.

Competition by tax-exempt organizations with private, taxpaying business is not wholly outlawed, however, by the 1950 amendments. For one thing, not all tax-exempt organizations taxed under § 511 on their "unrelated business income." Among the exclusions are churches and organizations described in §§ 501(c)(4) and (7). Nor does the tax apply to the income of certain organizations whose very function is competitive, to some degree at least, with private enterprise: organizations described in § 501(c)(8) (fraternal insurance societies); 501(c)(14) (credit unions); 501(c)(13) (cemetery companies); 501(c)(12) (certain life insurance and other associations); 521 (cooperative marketing organizations); and 501(c)(9), (10), and (11) (certain employees' retirement and insurance groups). Moreover, the term "unrelated business income" does not embrace a number of activities carried on by tax-exempt organizations, such as university restaurants and cafeterias, bookstores, research projects, *etc.*

Even after allowing for all of the omissions and exclusions, however, the 1950 changes will deny tax-exemption to most commercial and industrial activities carried on by an otherwise tax-exempt organization. The fear that tax-exempt organizations would undersell and then buy up or crowd out their competitors was frequently voiced in the hearings; this possibility also played a role in the Tax Court's opinion, *supra*, and in *United States* v. *Community Services, Inc.*, 189 F.2d 421, 425 (4th Cir. 1951), another case declining to follow the *Roche's Beach* case.

Is it possible that other macaroni makers might *prefer* to compete with a company operated by, or responsible to, trustees whose training and responsibility incline them to caution, rather than with an independent corporation operated in the interest of private stockholders? If the price charged by the Mueller Company for macaroni before its acquisition by New York University was calculated to return it the most profit, would the removal of income tax liability in itself make a lower price more profitable? Underselling aside, does the tax-exempt organization's power to borrow to buy a business, repaying the loan as well as financing expansion out of tax-exempt earnings (see again the way the acquisition of the old Mueller Company was to be financed, and consider also the capital gain problem raised *supra*, p. 423), constitute a threat to the continuation of private enterprise? Note that investment income (interest, rentals, dividends, *etc.*) is left untaxed by the 1950 amendments. Is there a danger that universities will drive out competition in this area by cutting interest rates, *etc.*?

3. Although most rents are not taxed as "unrelated business income," see § 512(b)(3) and (4), there is an exception for rents received under certain business leases. These are leases of real property for five years or more (actually, occupancy may sometimes take the place of a five year lease) where the tax-exempt organization borrowed to acquire or improve the property. Rent from such property is taxed to the organization in the proportion that the indebtedness incurred to purchase or to improve the property bears to its adjusted basis.

Before 1950, tax-exempt organizations were able to purchase industrial and commercial property (often through a purchase and lease-back of the kind involved in the *Century Electric Co.* case, *supra*, p. 411, using borrowed funds if necessary to finance the purchase. The institution would then rent the property to responsible

tenants on long-term "care-free" leases (*i.e.*, the tenant would be responsible for taxes, maintenance, *etc.*, as well as paying rent), and thus would assume relatively little risk of loss. Out of the rentals paid by the tenants, which were not taxable because of its exempt status, the institution would pay the interest and amortization on any borrowed funds, and it would be left with some additional amount as a return on its own investment, if any, or as profit. In addition, at the termination of the lease period the institution would own the building (which, of course, might be substantially depreciated) and the land, unless the tenant exercised an option to purchase, in which event the institution would realize the proceeds of sale. By such a boot-strap operation, Union College purchased $16,150,000 of department store properties with only $150,000 of its own funds, and leased them back to the previous owner for 30 years (with an option to renew for a like period) at a rental sufficient to pay the interest on, and amortize, the $16,000,000 of indebtedness, the tenant engaging also to pay taxes, insurance, maintenance, *etc.*

Under the 1950 amendments, to use the Union College transaction as an example, 1600/1615 of the first year's rentals would be taxed, the percentage changing in later years as the debt is amortized and the property's adjusted basis changes because of depreciation and other adjustments. See Note, Taxation of Sale and Lease-Back Transactions, 60 *Yale L.J.* 879 (1951); and, for other aspects of sale and lease-backs, see Cary, "Corporate Financing Through the Sale and Lease-Back of Property; Business, Tax, and Policy Considerations," 62 *Harv. L. Rev.* 1 (1948), Cary, "Current Tax Problems in Sale, or Gift, and Lease-Back Transactions," *9th Annual N.Y.U. Inst. on Fed. Taxation* 959 (1951).

4 As indicated in the foregoing paragraph, rent (except for amounts received under a "business lease") does not constitute "unrelated business income." Could New York University arrange to receive the profits of the macaroni business as "rent" instead of as dividends from the corporation? Suppose the corporation is dissolved by the university, and a new corporation is formed to which the plant, equipment, trade names, *etc.*, are leased by the university for a percentage of the net profits of the business. Would the rent be deductible by the corporation? Would it be taxed to the university? See Regs. 118, Sec. 39.422-1; *White* v. *Fitzpatrick, supra*, p. 358; MacCracken, "Selling a Business to a Charitable Foundation," 1954 *So. Calif. Tax Inst.* 205.

5 For background, see Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 *U. of Pa. L. Rev.* 617 (1950); and for the 1950 amendments, see Eaton, "Charitable Foundations and Related Matters Under the 1950 Revenue Act," 37 *Va. L. Rev.* 1, 253 (1951), Brown, "The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes," 13 *U. of Pitt. L. Rev.* 623 (1952); Comment, Colleges, Charities, and the Revenue Act of 1950, 60 *Yale L.J.* 851 (1951); Latcham, "Charitable Organizations and Federal Taxation," 3 *W. Res. L. Rev.* 99 (1951)

MABEE PETROLEUM CORP. v. U. S.

U. S. Court of Appeals, Fifth Circuit, 1953
203 F.2d 872

Before HUTCHESON, Chief Judge, and HOLMES and RIVES, Circuit Judges.

RIVES, Circuit Judge.

Appellant, Mabee Petroleum Corporation, claiming exemption under Section 101(6) of the Internal Revenue Code, brought this suit to recover income taxes paid for the years 1948 and 1949.

The questions presented are whether appellant corporation is entitled to the claimed statutory exemption as having been "organized and operated excusively for religious, charitable, scientific, . . . or educational purposes," within the mean-

ing of the above statute, and whether any part of the appellant's net earnings "inures to the benefit of any private shareholder or individual," in such manner as to disqualify appellant from claiming the exemption.

John E. Mabee, a Texas oil producer and multimillionaire, and his wife, L. E. Mabee, had for many years prior to 1947 been donating substantial sums of money to various charities. In that year they became dissatisfied with the lack of system and organization involved in their contributions, and felt that some of their money had not been wisely expended. They determined to set aside certain oil producing properties to be used exclusively for charitable purposes. Mr. Mabee selected the properties to be devoted to charities from among the holdings of the Mabee Oil & Gas Company, the stock of which corporation was owned by Mr. and Mrs. Mabee. He directed John Donnelly, the office manager, and Logan Stevenson, his attorney, to formulate a "good sound business plan so that we could give this money away to charity," and left the details to them.

The plan devised by Mr. Donnelly and Mr. Stevenson provided for the division of Mabee Oil & Gas Company into two corporations, Mabee Petroleum Corporation, and Mabee Royalties, Inc. Appellant, Mabee Petroleum Corporation, was to receive and operate the properties to be devoted to charities, while Mabee Royalties, Inc. was to receive the remaining properties. The J. E. & L. E. Mabee Foundation, Inc., was to be organized solely as a charitable corporation, and all of the stock and income of Mabee Petroleum Corporation was to be transferred to this Mabee Foundation to be used by it in furtherance of its charitable purposes.

Pursuant to the above plan, appellant corporation and Mabee Royalties, Inc. were organized on September 10, 1947, under the laws of Delaware. Appellant's charter and by-laws were those of the ordinary business corporation organized for profit. . . .

All oil properties other than those selected by Mr. Mabee for transfer to appellant were transferred to Mabee Royalties, Inc., in accordance with the plan. The stock of that corporation was issued to Mr. and Mrs. Mabee, and Mabee Oil & Gas Company was dissolved on July 20, 1948.

The Mabee Foundation was organized under the laws of Delaware on July 12 1948. . . . On September 24, 1948, appellant distributed $1,500,000 to the Mabee Foundation, and approximately a year later, on September 30, 1949, it distributed to it another $1,000,000. This $2,500,000 constituted all of the net income of appellant for its fiscal years 1948 and 1949, except possibly J. E. Mabee's salary hereinafter discussed.

Appellant has functioned since its organization solely for the purpose of receiving the selected oil properties, operating them and supplying the Mabee Foundation with funds for its various charities. The undisputed evidence is that appellant has made no attempt to expand its operations or acquire any properties. It has merely produced oil from the properties held for the Mabee Foundation. The Commissioner has ruled that the Mabee Foundation is exempt from income taxes under Section 101(6) of the Internal Revenue Code.

The Mabee attorney, Logan Stevenson, had suggested at a meeting of the directors shortly after appellant's organization that Mr. Mabee be employed at a salary for his services commensurate with his experience and ability and, at that time, he was employed as President and Manager of appellant for fifteen years at an

annual salary of $100,000. This salary was paid Mr. Mabee during the years ending September 30, 1948, 1949 and 1950. Accordingly, when the stock of appellant was transferred to the Mabee Foundation on September 1, 1948, the agreement relative to Mr. Mabee's employment and salary with appellant was called to the attention of the trustees of the Foundation. The trustees did not approve the agreement as a salary contract, but at their meeting agreed to accept the stock of appellant as a gift, with Mr. Mabee's salary obligation attached.

The District Court, in an oral opinion, found as a fact that the $100,000 per annum paid to J. E. Mabee as a salary was unreasonable compensation for his services, that such payments resulted in the inurement of a part of the net earnings of the appellant to him, and that appellant was therefore not entitled under the statute to the exemption claimed.[1] The Court made no specific finding as to whether appellant was organized and operated exclusively for charitable purposes.

Pretermitting the issue of whether appellant was organized and operated exclusively for charitable purposes within the meaning of the statute, we think the District Court correctly held that appellant was not entitled to the statutory exemption because a part of its net earnings inured to the benefit of J. E. Mabee in the guise of salary. The question of whether the salary payments constituted reasonable compensation for his services as president of appellant during the tax years involved was purely a question of fact, to be resolved by the District Court under all the existing circumstances. See *Leedy-Glover Realty* & *Ins. Co.* v. *Commissioner* 5 Cir., 184 F.2d 833; *American Pitch Pine Exp. Co.* v. *Commissioner* 5 Cir., 188 F.2d 721. Considerations of whether this Court might have reached a contrary determination under all the evidence are not controlling where, as here, appellant's evidence is not so compelling in character that we can regard the adverse decision as "clearly erroneous". Rule 52(a), Federal Rules of Civil Procedure, 28 U.S.C.A.; *Burford-Toothaker Tractor Co.* v. *Commissioner*, 5 Cir., 192 F.2d 633, certiorari denied, 343 U.S. 941, 72 S. Ct. 1033; *United States* v. *Yellow Cab Co.*, 338 U.S. 338, 340-342, 70 S. Ct. 177, 94 L. Ed. 150. Without undertaking to set out all the testimony, we draw attention to relevant factors which strongly support the District Court's holding.

It is without dispute that J. E. Mabee devoted only part of his time to his position as president of appellant. The evidence shows that during the same period he was receiving the salary payments in question, he was connected with at least six or seven other large organizations. He had previously served as president of Mabee Oil & Gas Company without salary, before the assets of that corporation

[1] In the course of its oral opinion, the Court observed:

"The testimony . . . does disclose that the Foundation did receive two and a half million dollars from the plaintiff, and, that a number of bequests, quite worthy ones, indeed, were made by the Foundation. However, at this same time, Mr. Mabee was receiving one hundred thousand dollars a year. That is a lot of money. And, if we look at that a moment, we must discover that it did not arise, probably, so much from a superlative business ability, but, it did arise from the hidden gold in the earth of his land, oil, cattle that grazed from the land.

"At the time that he was receiving this one hundred thousand dollars per year out of the plaintiff's earnings, which reduced its net, of course, he was connected with six or seven other different concerns, more than half of which he was president of.

"So that I hold, as a matter of fact, gentlemen, that that one hundred thousand dollars is an unreasonable compensation to be paid to Mr. Mabee, and, that that must tie up, and, did, in all probability, enter into the reason for the compactness of his estates, which were in seven states, and, two hundred oil wells, and, sixty different leases."

upon reorganization were divided between appellant and Mabee Royalties, Inc. The arrangement whereby the gift of appellant's stock was accepted by the Mabee Foundation with the obligation to pay the $100,000 annual salary attached supports the inference that the purported salary payments were not intended merely to compensate him for services to be rendered, but were really authorized to assure him substantial distributions of appellant's annual net earnings in the form of salary. We think it doubtful whether comparable services would have cost as much had they been acquired in an arms-length transaction from an outside source. Moreover, in fixing the salary for a fifteen-year period, no consideration was given to possible future changes in oil prices or general business conditions. J. E. Mabee was admittedly 67 or 68 years of age when the disputed salary payments were authorized, and he was thereby assured $100,000 per year until he was 82.

Appellant argues that tax-avoidance was no motive in voting the salary payments, and states that if such considerations had been paramount any number of more effective plans tax-wise could have been legimately adopted. While we expressly disavow any intimation of bad faith or tax-avoidance motives on the part of J. E. Mabee and his associates in devising the salary plan in question, we nevertheless cannot say under the circumstances of this case that the finding of the District Court as to the unreasonableness of the salary was "clearly erroneous". Rule 52(a), Federal Rules of Civil Procedure, *Burford-Toothaker Tractor Co.* v. *Commissioner, supra.*

We concede the logic of appellant's argument that the payment of reasonable salaries to corporate officers does not constitute inurement of net corporate income to the recipient within the meaning of Section 101(6), *supra.* In *Home Oil Mill* v. *Willingham,* D.C., 68 F. Supp. 525, 529, cited and relied upon by taxpayer in brief, the District Court specifically found the salary payments in question "to be reasonable and a fair compensation and salary . . . for actual services performed . . . ." See also *Willingham* v. *Home Oil Mill,* 5 Cir., 181 F.2d 9, certiorari denied 340 U.S. 852, 71 S. Ct. 80, 95 L. Ed. 624. The clear implication of such decisions, however, is that if the salaries involved had been found excessive and unreasonable an inurement of corporate net income would have resulted so as to disentitle the organization to the claimed exemption. The familiar principle that corporate net earnings may not be channeled to officers in the form of excessive and unreasonable salaries is too well settled to require citation of authority.

Regardless of whether the District Court's observation that "there must be a strict construction of such exempt legislation" was appropriate or applicable here, it cannot affect the finding as to the unreasonableness of the salary payments in question, on which basis the claimed exemption was disallowed.

> Even the most liberal of construction does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. (*Better Business Bureau* v. *United States,* 326 U.S. 279, 283, 66 S. Ct 112, 114, 90 L. Ed. 67.)

Finally, appellant argues that the payment of money as a condition to the acquisition of properties does not result in the inurement of net earnings, in contravention of the statute. See *Lederer* v. *Stockton,* 260 U.S. 3, 43 S. Ct. 5, 67 L. Ed. 99. If sound, this contention would furnish a ready means of avoiding the statutory requirement, that no part of the net earnings of the charitable corporation inure

to the benefit of a private individual. However, appellant and the Mabee Foundation were separate corporate entities, and we think it clear that the transfer of appellant's stock, subject to the salary contract entered into by appellant corporation with J. E. Mabee, did not qualify appellant for exemption. See *Universal Oil Products Co.* v. *Campbell*, 7 Cir., 181 F.2d 451, certiorari denied 340 U.S. 850, 71 S. Ct. 78, 95 L. Ed. 623; *Bear Gulch Water Co.* v. *Commissioner*, 9 Cir., 116 F.2d 975, certiorari denied, 314 U.S. 652, 62 S. Ct. 99, 86 L. Ed. 523; *Sun-Herald Corp.* v. *Duggan*, 4 Cir., 160 F.2d 475.

Having failed to satisfy one of the specific requirements of Section 101(6) of the Code, appellant is not entitled to the exemption claimed.

Affirmed.

HOLMES, Circuit Judge (*dissenting*).

We have here no evidence of fraud, intent to evade taxes, or desire for private advantage, on the part of these philanthropists. The evidence indicates clearly that the salary of $100,000 per year to the recipient merely added ordinary income to an already high-bracketed return, resulting in very little benefit to the taxpayer, the government being the greatest beneficiary. Commensurate with his experience in the particular field, the size, value, and extent of the properties under his management, and the other circumstances, the salary paid to Mr. Mabee is not unreasonable. As pointed out in appellant's brief, if the Mabees had desired to profit personally by the plan, there were several other methods whereby they could have done so without question.

The payment of reasonable salaries does not defeat the exemption of an otherwise charitable organization. *Willingham* v. *Home Oil Mill*, 5 Cir., 181 F.2d 9, certiorari denied, 340 U.S. 852, 71 S. Ct. 80, 95 L. Ed. 624; *Home Oil Mill* v. *Willingham*, D.C., 68 F. Supp. 525; *Sand Springs Home*, 6 B.T.A. 198. Moreover, these salary payments were obligations assumed in the acquisition of the trust property. *Lederer* v. *Stockton*, 260 U.S. 3, 43 S. Ct. 5, 67 L. Ed. 99, affirming 3 Cir., 266 F. 676; *Commissioner of Internal Revenue* v. *Orton*, 6 Cir., 173 F.2d 483, affirming *Ceramic Foundation*, 9 T.C. 533; 40 B.T.A. 555, wherein the Board of Tax Appeals said:

> Petitioner's only activity during the taxable years which was not strictly of a charitable or educational character was the payment of the allowance to the decedent's widow and the educational expenses of her nieces and nephews. We do not think that that alone defeats its classification as an exempt corporation under the statute.
>
> The payment of these amounts was merely incidental to and was a means of furthering the charitable and educational purposes for which the petitioner was organized. It was in no sense a part of its corporate activities. The payments made to the widow and nieces and nephews were a charge not upon the petitioner's net earnings but against the entire corpus of the residuary estate.

It is true that exemptions from taxation generally must be strictly construed, but this means that doubtful laws must be strictly construed. It does not mean, where the law is a liberalization in favor of the taxpayer and clearly applicable, that it should be technically administered to thwart a benevolent purpose because of a mistake of judgment by trustees as to the reasonableness of the salary of one employee in a vast enterprise. This single item, which was terminated at the end of three years, was a bagatelle to the man who received it in one hand and with the other dispensed millions to aid his fellow man in religious, scientific, and

educational activities, and to relieve human suffering in the treatment of diseases. *Roche's Beach, Inc.* v. *Commissioner*, 2 Cir., 96 F.2d 776.

I would reverse the judgment appealed from and render judgment here for the appellant.

Note

1. If the Mabee Petroleum Corporation was "operated for the primary purpose of carrying on a trade or business for profit," as seems probable, tax exemption would be denied for later years on the independent ground set out in Section 502, adopted in 1950. But if the corporation could qualify as a "feeder" under Section 501(c)(2), it would be entitled even now to tax exemption unless the salary paid to the founder was a disqualification. Do the net earnings of an otherwise qualified organization inure "to the benefit of any private shareholder or individual" if its capital or income is used (a) to pay off indebtedness incurred in acquiring the assets, or (b) to pay an annuity or other charge to which the assets were subject when conveyed to the organization? See *Commissioner* v. *Orton*, 173 F.2d 483 (6th Cir. 1949).

2. The Revenue Act of 1950 reformed this field to some degree also. Section 503 sets out certain "prohibited transactions" that will result in a loss of tax exemption until the organization satisfies the Secretary of the Treasury that it will not knowingly enter into another prohibited transaction. Some of the transactions specified in § 503 might have resulted in loss of tax exemption, even before the statutory change, under the "net earnings" or "organized and operated exclusively" provisos of § 501(c)(3), but the Treasury now has the benefit of statutory specification.

Section 504 denies tax exemption to certain § 501(c)(3) organizations (the same ones to which § 503 is applicable) if they unreasonably accumulate income, use income for non-exempt purposes, or invest income so as to jeopardize their tax-exempt function. Both § 503 and § 504 are designed primarily to penalize "private" charitable foundations that, by reason of their continuing relations with their grantors, may serve private interests more effectively than public interests.

3. Tax exemption may be denied where the claimant organization serves some business or private function of the grantor, even though there is no actual diversion of or jeopardy to its funds. See *Harvey* v. *Campbell*, 107 F. Supp. 757 (N.D. Tex. 1952) (organization to assist employees of grantor's business enterprise held not charitable), but *cf. Havemeyer* v. *Commissioner, supra*, p. 165, *Universal Oil Products* v. *Campbell*, 181 F.2d 451 (7th Cir. 1950) (research development corporation held not educational or scientific where discoveries were available without charge to donors but others were required to pay); *Underwriter's Laboratories, Inc.* v. *Commissioner*, 135 F.2d 371 (7th Cir. 1943). Note, however, that an organization that does not qualify under § 501(c)(3) as educational, charitable, scientific, etc, may come under some other exemption, such as § 501(c)(6). In this event its own income will be tax-exempt, but contributions to it will not qualify as deductions under Section 170. The organization cannot qualify even under § 501(c)(6), however, if organized for profit or if its net earnings inure to the benefit of private shareholders or individuals. *General Contractors' Ass'n.* v. *United States*, 202 F.2d 633 (7th Cir. 1953); *American Automobile Association* v. *Commissioner*, 19 T.C. 1146 (1953).

AVIATION CLUB OF UTAH v. COMMISSIONER

U. S. Court of Appeals, Tenth Circuit, 1947
162 F.2d 984

Before BRATTON, HUXMAN, and MURRAH, Circuit Judges.

MURRAH, Circuit Judge.

By this appeal, we are asked to review the holding of the Tax Court to the

effect that the Aviation Club of Utah was not in the years 1942 and 1943 exempt from income taxes under Section 101(9),* as a club "organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder." The Commissioner determined that the extraordinary revenue realized from the operation of the Club during the years 1941, 1942 and 1943, took it out of the exempt status contemplated by Section 101(9). The Tax Court held that the income for the taxable year 1941 was sufficiently incidental to the permissible purposes of the Club to come within the exemption, but that the income for the taxable years 1942 and 1943 was so completely disproportionate to the nonprofitable purposes of the Club as to render it taxable for those years. Our sole question is whether or not there is warrant in the record and a reasonable basis in the law for the decision of the Tax Court. The facts are not in dispute.

Petitioner was organized in 1940 by thirty persons living in or near Salt Lake City who were interested in aviation. Each of the thirty persons loaned $100 to the Club, which was used to make the initial payment on a residence to be used as a clubhouse. In brief, the Articles of Incorporation and By-laws of the Club provided for a nonprofit corporation without capital stock. Its purposes were to promote the interest of aviation, and sponsor cultural, fraternal, social and educational activities for its members. No profits were to be distributed to any of the members, except in the case of dissolution of the corporation.

The Club, being without funds, entered into an agreement with one Jensen to furnish, equip and operate the Club for 20 to 40 per cent of the profits, depending upon the amount realized. The agreement also provided that upon its termination, the Club could acquire title to the furniture and equipment for the amount of Jensen's investment therein. As manager of the Club, Jensen was subject at all times to the directions of the Board of Directors with respect to the kind of service to be rendered, prices charged, and the general policy of the Club. Since the organization of the Club, regular members have paid monthly dues of $2.00.

Only members who paid dues were permitted to vote and hold office; no initiation fees were charged; the clubhouse was not open to the public; however members were allowed to bring guests, and "guest members" who were out-of-town friends of regular members were also accorded privileges of the Club. They were issued guest cards, but were not charged any dues, nor were they permitted to vote as regular members.

In the early part of 1942, the headquarters of the Ninth Service Command was moved to Salt Lake City, and the Army Air Force established a number of bases nearby, as a result of which there was a tremendous influx of military personnel, and all facilities in the Salt Lake City area became quickly overtaxed. U. S. O. centers were established for enlisted men, but there were no comparable places of recreation for officer personnel. To meet this exigency, those charged with the responsibility of maintaining the morale of officers called upon all private clubs in the area to open their doors to army officers. The Chamber of Commerce of Salt Lake City participated in the appeal for all clubs to make their facilities available to officers as a patriotic duty.

Petitioner responded to this request, and the uniform of an officer became

* Now § 501(c)(7), 1954 Code. [Ed.]

sufficient credentials for admittance to the Club, and to receive a "guest membership" card to be used during his stay in Salt Lake City. As such, he was entitled to the same privileges of the Club, and at the same prices as regular members. During 1942 and 1943 thousands of officers availed themselves of the Club's facilities, and there is no dispute that the food and drink furnished on the premises was the best obtainable, at prices comparable to other places of business. At times the Club was so crowded, it was necessary to refuse admittance to guest members, but regular members were always permitted to use the "east door". The average number of members in 1941 was 212, 162 in 1942 and 154 in 1943. Between 3,000 and 4,000 guest cards were issued during 1942, and between 9,000 and 10,000 during 1943. The total revenue of the Club during 1941 was $14,881.70; $111,-606.37 in 1942; and $268,103.43 in 1943, the greater portion of which was derived from the bar and slot machines, and the balance from meals, music box and rooms.

None of the income of the Club has been distributed to its members, except that the thirty charter members were repaid their original loan of $100. In 1945, the Club exercised its option to purchase the furniture and equipment in the Club belonging to Jensen at a price of $28,000, and made extensive plans for improvement of the property. After V-J Day in 1945, the practice of admitting officers as guest members was discontinued, and the Club received letters from the various commanding officers expressing their gratitude for courtesies extended by the Club to military personnel during the war.

In holding that the revenue derived from the operation of the Club for the taxable years 1942 and 1943 was taxable as corporate income, the Tax Court cited and relied upon those related cases which hold in effect that where a Club of this kind, otherwise exempt under Section 101(9), engages in extra activities amounting to a substantial and continuing business for profit, the revenue from which inures to the benefit of the members, although not distributed, it loses its exempt status. *West Side Tennis Club* v. *Commissioner*, 111 F.2d 6, 130 A.L.R. 103, certiorari denied 311 U.S. 674, 61 S. Ct. 40, 85 L. Ed. 434; *Jockey Club* v. *Commissioner*, 2 Cir., 76 F.2d 597.

Those cases draw a clear distinction between clubs which operate a substantial and continuing business, the revenue from which inures either directly or indirectly to the benefit of the members in the nature of permanent club improvements, and those which operate a business venture for profit, yet such profits do not and cannot inure to the benefit of the members, but support and maintain a wholly exempt organization, *Trinidad* v. *Sagrada Orden, etc.*, 263 U.S. 578, 44 S. Ct. 204, 68 L. Ed. 458; *Roche's Beach, Inc.* v. *Commissioner*, 2 Cir., 96 F.2d 776, *Debs Memorial Radio Fund* v. *Commissioner*, 2 Cir., 148 F.2d 948, or those cases where the revenue is derived from isolated transactions, such as a sale of a part of its property, *Santee Club* v. *White*, 1 Cir., 87 F.2d 5; *Koon Kreek Klub* v *Thomas*, 5 Cir., 108 F.2d 616. See also Annotation 130 A.L.R. 107.

The Tax Court pointed out that in our case, the revenue derived from the operation of the Club was not merely incidental or indirectly related to the exclusive operation of the Club for pleasure, recreation and other nonprofitable purposes. It was emphasized that the greatly disproportionate revenue was derived from the operation of the Club through an arrangement with the manager Jensen, who was operating the Club on a percentage basis, and that the Club realized a profit along with Jensen; that those profits thus realized were used to improve the

facilities of the Club, which the members would thereafter enjoy at no cost to themselves. In sum, the Court was of the opinion that the Club conducted a substantial and profitable business during the taxable years which had only an indirect relation to the original purpose for which it was created, thus destroying its tax exempt status.

The factual line between taxability and nontaxability is not clearly definable, nor always consistent. See *Scofield* v. *Corpus Christi Golf & Country Club*, 5 Cir., 127 F.2d 452; *Coeur D'Alene Country Club* v. *Viley*, D.C. 64 F. Supp. 540. But it is clear that when a club, otherwise exempt, engages in a business from which it derives profits from outside sources wholly disproportionate to its nontaxable purposes, and such profits inure to the benefit of its members in the nature of permanent improvements and facilities, it loses its exempt status under the definitive provisions of the statute. It should be noted that to be exempt from taxation, the club must not only be organized exclusively for pleasure, recreation and other nonprofitable purposes, but it must be operated exclusively for those purposes as well.

We have no doubt that the activities of the Club during the years 1942 and 1943, resulting in very substantial profits, although prompted by purely patriotic motives, amounted to a substantial business, and that the profits thus realized did inure to the benefit of the members. The predominant activity of the Club during these years was the business of selling entertainment to persons other than members, which was certainly not incidental to its organizational purposes.

The judgment is affirmed.

Note

1. Section 501(c)(7) organizations are not taxed on their "unrelated business income" under § 511(a)(2), and even if they were, the income of the Aviation Club of Utah might be considered to be related, rather than unrelated, to its tax-exempt functions

2. Would the income in question have been taxable if used by the taxpayer in such a way as not to benefit its members, *e g.*, for charitable donations or the entertainment of enlisted men? If a § 501 (c)(7) organization's profits from charges to non-members are moderate in amount, are they tax-exempt even if used for the benefit of members? See R.R. 44, 53-1 C B. 109. Why is *any* of the income of a social or recreational club granted tax exemption?

3. Section 4241(a) imposes an *excise* tax on the dues and initiation fees of a "social, athletic, or sporting club or organization." Luncheon clubs for business and professional men have provided almost endless litigation as to whether "social" or business and professional interests were predominant See *Bankers Club* v. *United States*, 87 F. Supp. 253 (Ct Cl. 1949); Ray and Hammonds, "The Luncheon Club and the Federal Excise Tax," 28 *Taxes* 321 (1950). But a club may be able to escape the dues tax on the ground that it is not a social organization, without falling afoul of the income tax, since § 501(c)(7) exempts the income of "clubs . . . for pleasure, recreation, and *other* nonprofitable purposes."

CO-OPERATIVE OIL ASS'N v. COMMISSIONER

U. S. Court of Appeals, Ninth Circuit, 1940
115 F.2d 666

Before WILBUR, HANEY, and HEALY, Circuit Judges.

HANEY, Circuit Judge.

The question presented by the petition to review a decision of the Board of

Tax Appeals involves the right to deduct, as a liability to the members of a cooperative association, amounts earned but not distributed to such members.

Petitioner was incorporated in 1933 as a non-profit cooperative association under the laws of Idaho, and deals in petroleum products and auto supplies. Idaho Code Ann. § 22-2002, relating to such associations provides:

> Associations organized hereunder shall be deemed non-profit, inasmuch as they are not organized to make profits for themselves, as such, or for their members, as such, but only for their members as producers.

Membership in the petitioner is limited to those engaged in the production of agriculture products and is conditioned upon the purchase of one share of common stock and the execution of a membership agreement. Petitioner's authorized capital stock is 5,000 shares of $1 par common stock and 3,000 shares of redeemable non-voting, non-participating 6% $5 par preferred stock. The articles of incorporation contain the following provision:

> The net income of this corporation, except such amounts as by law are required to be set aside for reserve funds, or which may be set aside as reserve funds, by the Board of Directors or by vote of stockholders shall be distributed to the stockholding patrons of this corporation who have signed the corporation's purchasing agreement on the basis of their patronage and as shall be provided by the Board of Directors.

By virtue of that provision, it can be seen that the interest of a member in the earnings of petitioner is determined on the basis of "patronage" or amount of purchases.

Section 1, Article IX, of the by-laws is as follows:

> Before distribution of patronage dividends herein provided for it shall be the duty of the board of directors, and they shall have the right to retain and accumulate out of the net earnings of the corporation such amounts as, in the judgment of said board of directors are necessary and proper to create a reserve or reserve funds necessary to provide working capital and the proper facilities for carrying on the business of the corporation.

Section 1, Article X, of such by-laws provides:

> The net income of this corporation except such amounts as by law are required to be set aside as reserve funds, or which may be set aside as reserve funds, or which may be set aside as reserve funds by the board of directors, or by the vote of the stockholders shall be distributed to the stockholding patrons of this corporation who have signed the corporation's purchasing agreement on the basis of their patronage and as shall be provided by the board of directors. Such patronage dividends shall be ascertained and distributed by order of the board of directors at least once during each fiscal year of the corporation, and may be so ascertained and paid by order of said board twice each fiscal year, at the discretion of the board

The membership agreement provided in part·

> . . . before distribution of patronage dividends, it is the duty of the board of directors, and they shall retain and accumulate out of the net earnings of the corporation, such amounts as in their judgment are necessary and proper to create a reserve or reserve funds necessary to provide working capital, depreciation and other reserves and the proper facilities for carrying on the business of the corporation.

On May 1, 1934, petitioner sent to its members a circular letter which contained the following statement:

To All Members:

The attached draft or credit is only a part of your savings for the six months period ending January 31st, 1934. Your board of directors considers it desirable to retain a portion of the net profits of this period for working capital. As rapidly as our reserves accumulate these earnings will be released and disbursed to you as Patronage Refunds. In the meantime the money is being devoted to the excellent purpose of building your company and making possible larger dividends for the future.

Petitioner's earnings or "savings" for the period January 1, 1934 to November 1, 1934, amounted to $14,737.21. Petitioner claimed the right to deduct in its income tax return covering that period, that entire amount as a liability to members, although it actually declared and paid as dividends to members only $7,864.55. For the fiscal year ending October 31, 1935, petitioner's earnings were $29,073.83. Petitioner, in its income tax return for that period, claimed the right to deduct the entire amount as a liability to members, although it actually declared and paid dividends to the members in the amount of $17,926.53.

Respondent disallowed the deductions above referred to. The Board found that the earnings not paid out in dividends were placed in an account "Reserve for Working Capital," thus negativing the claim of liability to members. The Board further held that the deduction was not proper, in "the absence of some definite act of appropriation." Petitioner seeks review of the decision to that effect.

Petitioner contends that the Board's finding that the earnings not paid out in dividends were placed in reserve, is not supported by substantial evidence, and that its articles and by-laws specifically make its earnings belong to its members in any event. Petitioner does not set forth any theory as to what statute authorizes the deduction, even if its contentions are sound. No statute is cited to show that the deduction is authorized, if petitioner's contentions are correct, and we therefore assume that there is no such statute.

Petitioner does not contend that it is "exempt" from taxation under Int. Rev. Code, § 101(12)*. . . . Likewise, as stated, petitioner does not contend that the "deduction" claim is authorized by statute. The situation is fully set forth by the following quotation from respondent's brief, which is unchallenged by petitioner:

There is no express statutory provision permitting the deduction of so-called patronage dividends by corporations subject to taxation. The administrative practice, however, has been to permit cooperative associations, even though not exempt from taxation, to deduct from gross income the amounts returned to their patrons, whether members or non-members, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them.

In other words, petitioner points to no statute authorizing any deduction whatever, and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court. It is familiar law that "Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed" and "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." *New Colonial*

* Now § 521, 1954 Code. [Ed.]

Ice Co. v. *Helvering,* 292 U.S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348. See also: *White* v. *United States,* 305 U.S. 281, 292, 59 S. Ct. 179, 83 L. Ed. 172.

Petitioner makes no attempt to show that it is the object of legislative grace by pointing to a statute authorizing the deduction. The Congress has not legislated the deduction, and the courts cannot usurp that function. Whether respondent should have allowed the deduction he did allow is a question upon which we express no opinion.

Affirmed.

Note

1. The deduction referred to in the last sentence of the opinion was for the amounts actually paid as patronage dividends to members. Despite the doubt expressed by the court, the Treasury continues to allow a deduction (or, more precisely, an exclusion) for patronage dividends. One theory advanced to support the practice is that the cooperative organization acts as the agent of its patrons to buy or sell and, to the extent of its obligation to pay patronage dividends, has no income of its own. Another theory is that the organization on paying the dividend is simply adjusting the price of the products bought from or sold to the patron. See I.T. 3208, 38–2 C.B. 127; *Farmers Cooperative* v. *Birmingham,* 86 F. Supp. 201 (N.D. Iowa 1949); but see *National Carbide Corp.* v. *Commissioner,* 336 U.S 422 (1949), for a possible threat to the theory of excluding patronage dividends. These theories have been criticized on the ground that the patronage dividend is simply a percentage of the total business transacted by the co-operative with the patron, whether that business was profitable in itself or not, all members (and sometimes non-members) share in the organization's "earnings" (or "margin") in proportion to their total business with it. The *Cooperative Oil Ass'n* case has been explained as involving retained earnings that were not effectively credited to the members, and later cases have not insisted that the patronage dividend be paid out if it is credited to the accounts of the patrons. *Midland Cooperative Wholesale* v. *Commissioner,* 44 B.T.A. 824, 834 (1941); *Colony Farms Cooperative Dairy, Inc.* v. *Commissioner,* 17 T.C 688 (1951). It is essential, however, that the organization be under a duty to pay or credit the earnings to patrons. *American Box Shook Export Ass'n* v. *Commissioner,* 156 F.2d 629 (9th Cir. 1946); *United Cooperatives, Inc.* v. *Commissioner,* 4 T.C. 93 (1944).

The Senate Report states (p. 163) that patronage dividends paid by either exempt or taxable farm cooperatives do not constitute dividends within the meaning of § 34, relating to the dividends received credit. Why not?

2. The tax-exempt cooperatives to which the court referred must qualify under § 521: the organization must be controlled by patrons, treat non-members on a par with members in the allocation of patronage dividends, pay only limited dividends on its stock, and handle only a limited amount of non-member business. Until the Revenue Act of 1951, § 521 cooperatives were entirely tax-exempt. Since then, by reason of § 522, they are subject to tax, but may deduct amounts paid as dividends on capital stock and amounts allocated to patrons with respect to non-patronage business (*e.g.,* interest and dividends on investments, capital gains, earnings on business with the government, *etc.*). Neither deduction is allowed to non-exempt cooperatives. In addition, § 521 cooperatives may deduct (or exclude) patronage dividends in the same manner as non-exempt cooperatives. In substance, § 521 cooperatives are now taxed only on retained earnings not allocated or credited to patrons.

See generally Kassman and Sexton, "The Income Tax Treatment of Cooperatives," 7 *Nat'l. Tax J.* 50 (1954).

3. See Jacobs, "Cooperatives and the Income Tax Law," 31 *Taxes* 49 (1953); Note, Federal Taxation of Agricultural Cooperative Associations, 27 *Ind. L.J.* 447 (1952), Sutherland and Asbill, "Patronage Refunds by Exempt Cooperatives Under the Revenue Act of 1951," 30 *Taxes* 775 (1952), Bradley, "Classification for Tax Purposes

of Reserves of Tax-Exempt Cooperatives," 13 *Law & Contemp. Probs.* 526 (1948) and, for the broader issues of policy, Paul, "The Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes," 29 *Minn. L. Rev.* 343 (1945), Magill and Merrill, "The Taxable Income of Cooperatives," 49 *Mich. L. Rev.* 167 (1950); Adcock, "Patronage Dividends: Income Distribution or Price Adjustment," 13 *Law & Contemp. Probs.* 505 (1948), Rumble, "Cooperatives and Income Taxes," *id.* 534.

4. Mutual savings banks, previously tax-exempt under § 101(2) of the 1939 Code, were treated in somewhat the same way as tax-exempt co-ops by the Revenue Act of 1951. Their tax exemption was repealed, but a new provision, § 591, permitted them to deduct dividends paid or credited on deposits. Thus, only retained earnings (*i.e.*, amounts that do not constitute income to the depositors) will be taxable, except that a liberal deduction for additions to the bad debt reserve is also authorized. Savings and loan associations, also previously tax-exempt, were treated similarly. Bard, "Federal Income Taxation of Mutual Savings Banks," 30 *Taxes* 436 (1952).

Chapter 8

ACCOUNTING AND INCOME TAXATION

Section A. Accounting Methods – In General

1. Introductory

ACCOUNTING PRINCIPLES AND TAXABLE INCOME

American Accounting Association, 1952
27 Accounting Rev. 427
(Reprinted by Permission)

Summary

1. In the several statements of "Accounting Concepts and Standards Underlying Corporate Financial Statements" issued by committees of the American Accounting Association in 1936, 1941, and 1948, fundamental propositions concerning the functions of accounting in respect to revenue realization, costs, income, and capital were set forth. The objective in so doing was to present a coordinated statement of principles and suggested applications representing levels of accounting practice "departures from which should be viewed with concern."

2. Under the tax laws of the United States, Congress has enacted taxes on the net incomes of corporations. In the enactment of these laws and in their administration, by regulation or as a result of Court decisions, there have developed determinations of taxable income which are at variance from determinations of net income for financial statement purposes under generally accepted accounting principles.

3. These differences between taxable income and accounting net income may be classified generally into two principal categories:

(a) Differences of specification—those resulting from Congressional enactments designed to grant concessions as a matter of legislative grace or to deny or limit deductions as a matter of economic control or for purposes of raising revenue.

(b) Difference of timing—those which affect principally the time of recognition of income or of deductions, usually resulting from legalistic interpretations of the tax statutes by Court or regulative decisions (thereby setting a precedent for subsequent administration).

4. These differences result largely from differences in purpose. The purpose of the revenue laws is to establish practical formulae for the collection of taxes (and at times to regulate the economy). Financial accounting determinations of net income are designed to measure business results as they occur, without recognizing any artificial exclusions or modifications. Despite these differences in purpose, business has sometimes allowed its accounting practices to be influenced,

largely for convenience, by income tax provisions. In at least one case, also, the income tax law has undertaken to decree the procedures of financial reporting.*

5. The Committee has undertaken to examine these conditions for the particular purpose of dealing with the following questions:

(a) Recognizing that the purposes of defining a base for income taxation and of measuring net income for published financial statements do differ, to what extent, if at all, is it necessary or desirable for taxable income to differ from accounting net income?

(b) If such differences appear, to what extent should income tax practice be recognized in determining net income for financial accounting purposes?

(c) Should financial accounting procedures or reporting methods ever be decreed by Congressional statute?

6. The Committee's conclusions on these questions are as follows.

(a) The right of Congress to grant tax concessions as a matter of legislative policy, or to impose economic or social disciplines, or to deny deductions for the purpose of generating revenues, is unquestioned. However, neither the Congress nor the administrative authorities nor the Courts should undertake to modify the application of generally accepted accounting principles, consistently used by the taxpayer for published statement purposes, solely to alter the timing of recognition of income or expense for tax purposes.

(b) Corporate accounting practices for purposes of published financial statements should be governed wholly by generally accepted accounting principles, irrespective of measurements of taxable income under provisions of the tax laws.

(c) Accounting principles should not be formulated or public reporting methods prescribed by directives of the tax laws; the body of accounting principles and the methods of reporting should evolve from the needs and uses of the broad public interest.

Discussion

7. Since the enactment in 1913 of the first revenue act under the Sixteenth Amendment, there has been a notable and unfortunate lag in the legal appreciation of accounting principles. This was responsible for the failure to recognize the accrual concept in the early tax laws. The 1913 income tax law was largely one which, by its terms, assessed a tax against cash income. Because of the problems of interpretation of such a statute and the inequities inherent in it, the regulations and the laws in later years have given general recognition to the accrual principle.†

8. The revenue acts in force from 1913 to the present time have all provided for recognition of the method of accounting employed by the taxpayer. This is presently stated in Section 41 of the Internal Revenue Code ‡ as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

* Section 472(c) provides that a taxpayer may use the LIFO method of valuing inventories, *infra*, p. 683, only if no other method is used in reports to stockholders or partners and creditors. [Ed.]

† See Magill, *Taxable Income* (rev. ed. 1945) pp. 177–178. [Ed.]

‡ The same principles are to be found in §§ 441 and 446 of the 1954 Code. [Ed.]

9 Despite this promulgation, there has developed a widening gap between accounting net income and taxable income. The factors which have caused these variations are:

(a) Congressional enactments granting concessions (either by exclusions of income or allowances of special deductions from income), or imposing limitations or penalties for purposes of economic or social discipline or to protect the revenues. Examples are (1) the exemption of proceeds of life insurance policies, (2) the granting of percentage depletion allowances, (3) the denial of deductions for compensation paid in violation of wage stabilization laws, and (4) the limitations of deductions for contributions to charity.

(b) Legalistic interpretations of the tax statutes by administrative or Court decisions seemingly influenced largely by considerations of cash flow, in violation of the accrual principle of accounting. These are in the form of differences of timing of the recognition of income or deductions, examples of which are (1) the taxability of prepayments for services which are expected to be rendered in the future, and (2) the denial of deductions for accruals for known liabilities of indefinite amount.

10. The tax laws are designed to effectuate a special purpose—the raising of revenue. It is wholly within the rights of Congress to prescribe its definition of taxable income and, in so doing, to specify additions to or deductions from accounting net income as it sees fit. The allowance of percentage depletion, the exemption of certain reorganizations and like-kind exchanges, the denial of deductions for interest paid to carry tax-exempt securities or to purchase single premium life insurance policies, and other similar provisions, all recognize social, economic, and political considerations without containing any suggestions that they modify business accounting concepts.

11. With such specific and intended exceptions, however, the Committee believes that the public interest will best be served if the differences between taxable income and business income are reduced, and if the general mandate of Section 41 is permitted to take precedence over non-accounting interpretations of the individual provisions of the law. The principal differences of this character involve matters of timing of the recognition of income or deductions, ignoring consistent methods of accounting used by the taxpayer or recognized as general practices The Committee believes that, unless an important overriding consideration dictates a modifying legislative provision of the type described in paragraph 9(a), the interests of government, business, and the public, would best be served if the definition of business income subject to tax were made as nearly as possible coincidental with net income under generally accepted accounting principles, it therefore supports the view that differences of the type described in paragraph 9(b) should be eliminated by administrative regulation or, if necessary by legislation.

12. The tax laws have unduly and unintentionally tended to influence the development of corporate accounting in that to some extent legislative concessions in measuring taxable income have been adopted into accounting practice without justification in principle. An illustration of this is the instalment basis of reporting income, when the consideration is received over a period of time.§ There is no

§ When a taxpayer is to be paid in instalments, he may sometimes elect to recognize the income realized on the transaction as the instalment payments are received, instead of reporting the full amount of the income in the year the sale is made. *Infra*, p 693. [Ed.]

sound accounting reason for the use of the instalment method for financial statement purposes in the case of closed transactions in which collection is dependent upon lapse of time and the probabilities of realization are properly evaluated.‖ In the opinion of the Committee, such income has accrued and should be recognized in financial statements, even though deferred for tax purposes. Another example is the practice common during World War II of reflecting amortization of "emergency facilities" in financial statements in amounts corresponding to allowable tax deductions [see § 168], even though in some cases the expected useful life of the facilities was longer than the statutory sixty months.

13. In one notable respect, Congress has undertaken specifically to influence accounting practices by legislation, in that the law conditions the use of the LIFO (last-in first-out) method of inventory pricing upon a requirement that the valuation so determined be used for the purpose of reports or statements to shareholders, partners, or proprietors and for credit purposes. This requirement is an unwarranted and unnecessary encroachment and, in the opinion of the Committee, should be eliminated by legislation

Note

An extensive list of the places where tax accounting and business accounting part company may be found in Reimer, "Major Differences Between Net Income for Accounting Purposes and for Federal Taxes," 23 *Accounting Rev.* 305 (1948). Smith and Butters, in *Taxable and Business Income* (1949), report on a detailed comparison of "book profit" as reported by a number of corporations in their public reports to the Securities and Exchange Commission and the "statutory net income" as computed by the same corporations for tax purposes. For the companies studied, book profit typically exceeded statutory net income by less than ten per cent, and this difference was more or less wiped out by upward adjustments of statutory net income by the Bureau on its audit of the tax returns. For some industries, however, the difference was typically much greater, and this was especially so for mining and public utility corporations, where there are substantial differences in the handling of depletion and depreciation in computing book profit and statutory net income. Moreover, for individual companies there were also significant divergencies between book profit and statutory net income, though a difference in one direction in one year would sometimes be offset by a difference in another direction in a later year

See also Cannon, "Tax Pressures on Accounting Principles and Accountants' Independence," 27 *Accounting Rev.* 419 (1952); Lasser and Peloubet, "Tax Accounting v. Commercial Accounting," 4 *Tax L. Rev.* 343 (1949), Werntz, "The Influence of Changing Tax Rates on Accounting and Auditing Procedures," 28 *Taxes* 658 (1950); Caldwell, "Relationship Between Tax Accounting and the Requirements of Other Government Agencies," *11th Annual N.Y.U. Institute on Fed. Taxation* 207 (1953).

The 1954 Code contains several provisions "designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles" (S Rept. p. 62), and they will be encountered later in this chapter.

‖ On this point, see Supplementary Statement No. 1, issued December 31, 1950. Many accountants, including some members of this Committee, believe that methods consistently applied which accomplish a full matching of costs with revenue do not violate the accrual principle even though recognition is deferred until collection. However, if collection is reasonably assured, such a delay in recognition is not, in the opinion of the Committee, the best practice. Furthermore, where such methods are employed, disclosure is usually incomplete. In any event, the so-called instalment sales method as usually applied does not secure an adequate matching of revenues and costs.

2. *The Cash Receipts and Disbursements Method*

BLATTMACHR, KNAPP, AND WARREN
ACCOUNTING PERIODS AND ACCOUNTING METHODS
New York. Practising Law Institute, (1952) pp. 30–32
(Reprinted by Permission)

Historically, as well as under the Code, the fundamental method of reporting income is on a cash receipts and disbursements basis. Generally speaking, taxpayers using this method report items of income and deductions in the year when actually received or paid. No account is taken of bills rendered or received. Items of income earned by or due to the taxpayer are not included until actually *received*, and expenses incurred or payable are not deducted until actually *paid.* The relative simplicity of the application and use of this method makes it the choice of the large body of individual taxpayers who are salaried or professional people. Since billings need not be taken into account, the cash method usually does not require books of account or at most, requires the use of a very elementary system of bookkeeping. Where the taxpayer does not keep books, the courts have held that income must be reported on the cash basis. . . .

Although the cash method ordinarily implies the receipt of income or the payment of a deductible item, it is not limited to the actual receipt or payment of *cash* by the taxpayer. Receipt or payment may be in the form of equivalents of cash. Thus, income is realized when the taxpayer receives it regardless of its form, whether in cash, property or other benefits measurable in money's worth.[1] The amount received is determined by the arm's-length stipulated value or the market value at the time received.

Regardless of the form of payment, income results and a payment is made at the time when it is received or paid out and the controlling point of time is not when the equivalent of cash is later converted into cash money. Thus, where an employee receives corporate stock as compensation, he has obtained income to the extent of the fair market value of the stock at the time he receives the shares of stock; the receipt of taxable income is not regarded as being delayed until he sells the stock for cash. Similarly, taxable income is received when the note or check is received and not when the instrument is negotiated for money.

Although payment may be made in the form of property and thus entitle the taxpayer to a deduction to the extent of the value of the property, the issuance by a cash basis taxpayer of his own promissory note is not considered payment[2] even though secured by a deposit of collateral. Thus, a taxpayer was not considered as having paid interest due on an insurance policy loan where the "payment" was effected by increasing the amount of the loan and giving a note thereof secured by the policy.[3] The taxpayer in such instances is not considered as having actually made payment until he discharges his note.[4] Similarly, where the taxpayer borrowed $69,000 from a bank payable in five years and the bank deducted $8,000

[1] The statutory definition of income includes "of whatever kind, and in whatever form paid." I.R.C. § 22(a). [See § 61(a). 1954 Code.]
[2] Helvering v. Price, 309 U.S. 409 (1940).
[3] Keith v. Comm'r, 139 F.(2d) 596 (C.C.A.2d. 1944); Prime v. Comm'r, 39 B.T.A. 407 (1939).
[4] Spec. Ruling, 495 C.C.H. Stand. Fed. Tax Serv. ¶6062 (Jan. 17, 1949).

from the amount of the loan for the interest, the taxpayer was not considered as having paid the interest at that time.[5]

In order to constitute income, however, it is not necessary that payment be made directly to the taxpayer. A taxpayer may be considered as having received the benefit of a payment made to a third party. Thus, an employee may receive compensation for his services at the time his income taxes, the premiums on his insurance policy, or his debts are paid by his employer. So, too, a landlord will be held to have received additional rent in the year that his taxes or his mortgage payments are discharged by the tenant. . . .

AMEND v. COMMISSIONER

Tax Court of the U. S, 1949
13 T.C. 178

BLACK, Judge. We have two taxable years before us for decision, 1944 and 1946. . . .

In each of the taxable years there is one common issue and that is whether the doctrine of constructive receipt should be applied to certain payments which petitioner received from the sale of his wheat. There is no controversy as to the amounts which petitioner received or as to the time when he actually received them Petitioners, being on the cash basis, returned these amounts as part of their gross income in the years when petitioner actually received them. . . .

In applying the doctrine of constructive receipt, the Commissioner relies upon Regulations 118, section 39.42-2, printed in the margin.[1]

In *Loose* v. *United States*, 74 Fed.(2d) 147, the rule providing for the taxation of income constructively received is stated as follows:

> . . . the strongest reason for holding constructive receipt of income to be within the statute is that for taxation purposes income is received or realized when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession. So viewed, it makes no difference why the taxpayer did not reduce to actual possession. The matter is in no wise dependent upon what he does or upon what he fails to do. It depends solely upon the existence of a situation where the income is fully available to him. . . .

Respondent, in his brief, relies upon the *Loose* case, from which the above quotation is taken, and several other cases which deal with the doctrine of constructive receipt. Needless to say, each of those cases depends upon its own facts. In the *Loose* case, for example, interest coupons had matured prior to the de-

[5] John C. Cleaver, 6 T.C. 452 (1946), aff'd, 158 F.(2d) 342 (7th Cir. 1946), cert. den.

[1] SEC 39 42-2. INCOME NOT REDUCED TO POSSESSION—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession To constitute receipt in such a case the income must be credited or set apart to the tapxayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

cedent's death. The decedent had not presented them for payment because of his physical condition. It was held that, even though the decedent had not cashed them, the interest coupons represented income to him in the year when they matured, under the doctrine of constructive receipt.

It seems clear to us that the facts in the instant case do not bring it within the doctrine of *Loose* v. *United States, supra,* and the other cases cited by respondent dealing with constructive receipt.

In discussing the situation which we have in the instant case, we turn our attention first to the contract of sale which petitioner made of his 1944 wheat crop to Burrus. The testimony was that 1944 was a bumper wheat crop year and that petitioner produced and harvested about 30,000 bushels, some of which was lying out on the ground and some of which was stored on the farm. Petitioner, through his attorney in fact, Paul Higgs, sold this wheat to Burrus for January 1945 delivery at $1.57 per bushel. It was the understanding that petitioner would ship his wheat to Burrus at once and that Burrus would pay him for it in January of the following year. The contract was carried out. Some time during the month of August 1944, after August 2, petitioner shipped the 30,000 bushels to Burrus. Burrus received it, put it in its elevator, and paid petitioner for it by check dated January 17, 1945.

Respondent's contention seems to be based primarily on the fact that petitioner could have sold Burrus the wheat at the same price for immediate cash payment in August 1944 and that although he did not do so, he should be treated in the same manner as if he had and the doctrine of constructive receipt should be applied to the payments received. We do not think the doctrine of constructive receipt goes that far. Porter Holmes, who was the manager of the Burrus Panhandle Elevator in Amarillo at the time of the 1944 transaction, testified at the hearing. He testified that it was the usual custom of Burrus to pay cash for wheat soon after it was delivered and that the transaction between Burrus and petitioner for January 1945 delivery and settlement was unusual and that he telephoned the manager at Dallas, Texas, for authority to make the deal that way and secured such authority and the deal was made. He testified that when Burrus' check for $40,164.08 was mailed to petitioner January 17, 1945, it was done in pursuance of the contract. So far as we can see from the evidence, petitioner had no legal right to demand and receive his money from the sale of his 1944 wheat until in January 1945. Both petitioner and Burrus understood that to be the contract. Such is the substance of the testimony of both petitioner, who was the seller of the wheat, and Holmes, who acted for the buyer. Such also is the testimony of Paul Higgs who represented the seller in the negotiations for the sale. During 1944 all that petitioner had in the way of a promise to pay was Burrus' oral promise to pay him for the wheat in January 1945. Burrus was a well known and responsible grain dealer and petitioner testified that he had not the slightest doubt that he would receive his money in January 1945, as had been agreed upon in the contract. Such a situation, however, does not bring into play the doctrine of constructive receipt. See *Bedell* v. *Commissioner*, 30 Fed. (2d) 622, wherein the court said:

While, therefore, we do not think that the case is like a promise to pay in the future for a title which passes at the time of contract, we would not be understood as holding by implication that even in that case the profit is to be reckoned as of the time of sale. If a company sells out its plant for a negotiable bond issue

payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. . . . it is absurd to speak of a promise to pay in the future as having a "market value," fair or unfair. . . .

The doctrine that a cash basis taxpayer can not be deemed to have realized income at the time a promise to pay in the future is made was reiterated by the Circuit Court of Appeals for the Eighth Circuit in the more recent case of *Perry* v. *Commissioner*, 152 Fed.(2d) 183. In that case it was stated:

These cases seem to be predicated upon the fact that in a contract of sale of property containing a promise to pay in the future, but not accompanied by notes or other unqualified obligations to pay a definite sum on a day certain, the obligation to pay and the obligation to pass title both being in the future, there is an element of uncertainty in the transaction and the promise has no "market value," fair or unfair. This theory is supported by the decision of the Supreme Court in *Lucas* v. *North Texas Co.* . . .

The Commissioner in the instant case is not contending that Burrus' contract to pay petitioner for his wheat in January 1945 had a fair market value equal to the agreed purchase price of the wheat when the contract was made in August 1944. What he is contending is that petitioner had the unqualified right to receive his money for the wheat in 1944, that all he had to do to receive his money was to ask for it, and that, therefore, the doctrine of constructive receipt applies as defined in section 39.42-2, Regulations 118.

For reasons already stated, we do not think the Commissioner's determination to this effect can be sustained. If petitioner had begun this method of selling his wheat in 1944, when he had a bumper crop, there might be reason to doubt the bona fides of the contract, but what we have said about the 1944 transaction between Burrus and petitioner is based upon the finding that the contract between Burrus and petitioner was bona fide in all respects, though it was initiated by petitioner, and each party was equally bound by its terms. Petitioner did not begin this method of selling his wheat in 1944—he began it in 1942 and continued it through 1946. No doubt his taxes were more in some years and less in others than they would have been if petitioner had sold and delivered his wheat for cash in the year when it was produced. To illustrate this we need only point out that under the method which petitioner used he reported income in 1945 upon which he paid a tax of $2,672.64. His wife Eva also reported income and paid a tax of about the same amount. By treating petitioner's proceeds from the sale of his 1944 wheat as constructively received in 1944, the Commissioner determined overassessments as to each petitioner for 1945 and deficiencies against each petitioner for 1944.

Petitioner was asked at the hearing why he adopted the manner of selling his wheat which has been detailed in our findings of fact. His answer was as follows:

Well, that had been my practice, to handle that wheat that way since 1942 and I have handled my wheat that way, '42, '43, '44, '45, '46, '47 and into 1948. It is still my practice to do that and there have been some years in the interval that I would certainly have paid less income had I handled it the other way, but that is a semi-arid country and we are uncertain about our wheat crops and our expenses are always pretty well set and we know they are going to be high and we need for our own protection to carry part of this wheat forward. . . .

As I have already explained, it's been a matter of making my income more uniform and even; about five of those years had it all been set back and sold in the year that it was supposed to have been sold in, my income tax would have been less and in the other two it would have been more. I merely emphasize that to show the consistency of my policy and not as a matter of paying any tax.

Whether the reasons advanced by petitioner in his testimony quoted above are good or bad as a business policy, we do not undertake to decide. The question we think we have to decide is whether the contracts detailed in our findings of fact were bona fide arm's-length transactions and whether under them the petitioner had the unqualified right to receive the money for his wheat in the year when the contracts were made and whether petitioner's failure to receive his money was of his own volition. Our conclusion, as already stated, is that the contracts were bona fide arm's-length transactions and petitioner did not have the right to demand the money for his wheat until in January of the year following its sale. This being true, we do not think the doctrine of constructive receipt applies. See *Howard Veit*, first point decided, 8 T.C. 809.

Petitioner, in each of the years before us, returned as a part of his gross income the checks which he actually received in payment for his wheat. This being so, we think he complied with the income tax laws governing a taxpayer who keeps his accounts and makes his returns on the cash basis.

We have discussed in detail above only the sale which petitioner made of his wheat to Burrus in August 1944. The sale of his 1945 and 1946 wheat was made to Coffee-Davis Grain Co. under substantially the same circumstances as the sale to Burrus and it need not be separately discussed. . . .

Decisions will be entered under Rule 50.

Note

1. See generally Comment, Constructive Receipt: When Must the Taxpayer Pay? 45 *Ill. L. Rev.* 77 (1950).

2. Can an employee arrange with his employer to have his compensation paid in instalments over a period of time, including the period after retirement when he presumably will be in lower tax brackets? *Commissioner* v. *Oates*, 207 F.2d 711 (7th Cir. 1953), involved an attempt by the Bureau to tax a retired insurance agent on commissions accruing because policies written by him before retirement were renewed by the policyholders after his retirement. Under the contract in force when the policies were written, the commissions were to be paid by the insurance company for a period of 9 years after retirement to the full extent earned. Before the agent retired, however, he entered into an amended contract providing for payment of the commissions over a 15-year period. During the years 1944–46, about $100,000 in renewal commissions accrued under the taxpayer's contract. Under the original contract, he would have received this entire amount in these years, under the contract as amended, he received $31,000, and the balance remained with the company at interest to be paid out to him in later years. The court held that the original contract had been effectively amended and that the taxpayer was not taxable either on the doctrine of constructive receipt or under cases like *Lucas* v. *Earl*, *supra*, p. 298, and *Helvering* v. *Horst*, *supra*, p. 302.

See Barrett, "Current Developments in the Deferred Compensation Mystery," *11th Annual N.Y.U. Inst. on Fed. Taxation* 133 (1953); Eisenstein, "A Case of Deferred Compensation," 4 *Tax L. Rev.* 391 (1949); Freyburger, "Constructive Receipt of Income: Settlements Under Life Insurance Contracts," 30 *Taxes* 867 (1952). Does a taxpayer constructively receive an amount he refuses to receive? *Hedrick* v. *Com-*

missioner, 154 F.2d 90 (2d Cir. 1946); *Commissioner* v. *Giannini*, 129 F.2d 638 (9th Cir. 1942), G.C.M. 27026, *supra*, p. 299; Tritt, "Renunciation—Income Tax Problems," 1953 *So. Calif. Tax Inst.* 519. See also § 678(d).

3. On the use of escrows by cash basis taxpayers to postpone the receipt of taxable income, see *Kuehner* v. *Commissioner*, — F.2d — (1st Cir. 1954); Note. The Effect of Escrow Arrangements on Federal Income Tax Liability, 59 *Harv. L. Rev.* 1292 (1946).

WEIL v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1949
173 F.2d 805, cert. den. 338 U.S. 821

Before L. HAND, Chief Judge, and SWAN and CLARK, Circuit Judges.

SWAN, Circuit Judge.

These petitioners [two brothers] seek reversal of decisions determining deficiencies in their respective income taxes for the years 1939 and 1941. . . . Each case presents the same legal question, namely, whether payments actually received by the taxpayer in the years in suit should be treated as constructively received in earlier years in which he reported as income the amounts now in dispute.

Section 42 * of the Internal Revenue Code, lays down the general rule for reporting income, as follows

> The amount of all items of gross income shall be included in the gross income for the taxable years in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

Although the statute says nothing as to constructive receipt of income this doctrine has from the beginning been incorporated in the Treasury Regulations.†. . .

The doctrine of constructive receipt treats as taxable any income which is unqualifiedly subject to the demand of a taxpayer on the cash receipts and disbursements method of accounting, whether or not such income has actually been received in cash. *Ross* v. *Commissioner*, 1 Cir., 169 F.2d 483, 490. Although the doctrine was doubtless conceived by the Treasury in order to prevent a taxpayer from choosing the year in which to return income by electing when he will reduce it to possession, the regulation lays down a rule of uniform application, which the taxpayer as well as the Commissioner may invoke. So the Ross case held, and we agree with it. Hence if the facts show a constructive receipt of income in earlier years, the petitioners may assert the doctrine to defeat an attempt to tax it in a later year.

The taxpayers were the executors of the estate of their father, Jonas Weil, who died in 1917. The Surrogate's Court of New York County in which his estate was being administered entered a decree on February 11, 1932 and another in March 1940 directing the executors to pay to themselves certain sums.[1] The sums

* See § 451(a) of the 1954 Code, which is substantially the same. [Ed.]

† Regs. 118, § 39.42-2. [Ed.]

[1] The 1932 decree awarded each of the taxpayers $61,715.06 as executor's commissions for their services during the years 1917 to 1928 inclusive; it also awarded Benjamin $48,224 61 and Victor $9,370.34 as interest on large contract claims adjudged in their favor in 1927 and already paid them, but without interest, except for $868.32 paid on Feb. 26, 1932.

The 1940 decree awarded each of the taxpayers $29,141.38 as executor's commissions for the years 1930 to 1938 inclusive.

awarded by the 1932 decree were included by the taxpayers, who were on the cash receipts and disbursements basis, in their respective income tax returns for 1932; but by reason of losses claimed on worthless stock their returns showed no tax due. The income tax return for the Jonas Weil estate did not show payment of the 1932 awards to the petitioners; it showed a loss of some $90,000 without them. Although each petitioner reported the full amount of the award to him, the portion thereof actually received in cash in 1932 was $30,064.08 by Benjamin and $29,131 68 by Victor. The balance of the 1932 awards they collected in instalments during subsequent years, the final payments in 1939 being $31,862.67 to Benjamin and $11,953.72 to Victor. This payment the Commissioner ruled to be taxable in that year, thus producing the 1939 deficiencies.

The 1940 award of executor's commissions was similarly treated by the taxpayers as constructively received in that year. In his 1940 income tax return each taxpayer reported the full amount awarded him, and paid the tax thereon computed as though the amount were received during the years 1930 to 1938 inclusive, under the option granted to taxpayers by § 107(a)‡ of the Internal Revenue Code. The sum actually paid each taxpayer in 1940 was $5,000, and in 1941 each received an additional payment of $10,000 on account of the award. This is the item producing the 1941 deficiencies.

The Tax Court held that there was no constructive receipt by the petitioners of the sums awarded them by the 1932 and 1940 decrees for two reasons. (1) Because such sums "were neither credited to the accounts of the petitioners in those years, nor were they set apart for them in any manner"; and (2) because the Jonas Weil estate did not have sufficient cash during those years to pay the petitioners the amounts awarded them.

It is true, as the Tax Court found, that the estate did not set up the awards of the Surrogate's Court in favor of the petitioners as accounts payable, and the amounts of the awards were not credited on the estate's books in the years they were made, and no funds were segregated or set apart for them. But it is also true that the only books kept by the estate were books of cash receipts and disbursements. Having no ledger, the estate's only record of accounts payable would be the decrees of the Surrogate's Court directing the executors to make the payments. Section 39.42-2 of Regulations 118 does not require any particular type of bookkeeping. Indeed, the section itself clearly implies that a book entry is not the only way to establish a credit, since it provides· "A book entry, *if made,* should indicate an absolute transfer from one account to another" (italics added). Usually, of course, an entry on the obligor's books crediting a sum to the account of the obligee will be the best evidence that the obligee has only to reach out his hand to reduce the debt to possession, but it is not necessarily the only evidence that he has unfettered control of the money. See *Acer Realty Co.* v. *Commissioner,* 8 Cir., 132 F.2d 512, 515-516.

Assuming *arguendo* that, in the case of an estate where the books kept by the executors show only receipts and disbursements, probate decrees directing the executors to pay specified sums to themselves individually as fees or interest on their allowed claims against the estate may be considered as a "credit" of income to their personal accounts, within the meaning of the constructive receipt

‡ Similar to § 1301 of the 1954 Code See *infra*, p. 709. [Ed.]

regulations, the question remains whether, without more, it is a credit of income "which may be drawn upon by him [the taxpayer] at any time" and "without any substantial limitation or restriction as to the time or manner of payment." We think this question must be answered in the negative. It is elementary law that in probate administration, executors are regarded as separate legal persons in their individual and official capacities. The decrees directing payment leave it discretionary with the executors when the payment is to be made. In exercising their discretion they must consider the interest of the estate without regard to their personal interest with respect to receipt of payment. This is obvious when the estate has insufficient cash on hand and the executors must sell some asset or borrow money on the credit of the estate in order to obtain the necessary funds to make payment to themselves individually. They must choose the time to sell or borrow with an eye single to the interests of the estate. Even when the estate has cash on hand sufficient to pay the fees or interest awarded by a probate decree, their fiduciary duty requires them to consider whether payment should be temporarily deferred because the cash may be needed for other purposes, such, for example, as payment of taxes accrued or about to accrue. Consequently until the executors do something to indicate that their discretion has been exercised in favor of immediate payment to their personal accounts, they do not in their individual capacities have unrestricted control of the money. Had the executors kept a ledger account and credited the fee to the taxpayers' personal accounts that might suffice to show that they had only to ask for it to receive it. Had they done some other thing, for example, claimed credit for the payment in the estate's income tax return for the year in which the decree was entered, that might also show the immediate availability of the money to the taxpayers. But in the case at bar they did nothing in their official capacity to indicate that the money was immediately available to them in their personal capacity.

Nor was it shown to the satisfaction of the Tax Court that the condition of the estate in 1932 or 1940 was such that deferment of payment could not have been required in the interests of the estate. As the Tax Court's findings of fact noted:

> . . . The record does not disclose the extent of the liabilities either by stipulation or evidence. Nor is the record clear as to the amount or manner of payment of the current operating expenses of the estate. Therefore we do not find that during the year 1932 there were sufficient cash assets available in the Jonas Weil Estate to pay the claims of the petitioners for their executor's compensation and interest while at the same time paying the operating expenses and keeping a sufficient reserve to meet outstanding liabilities. From 1932 to 1941 the annual operating expenses were substantially the same each year. In 1933 they were $65,000 and in 1934, $69,000

The petitioners ask us to reverse the finding that sufficient cash was not shown to have been available to make the payments in 1932. . . . Upon the facts shown we do not think the court's findings with respect to the failure to prove the availability of cash to pay the petitioners in 1932 can be overruled.

With respect to the year 1940 the showing of available cash was less favorable than in 1932. The petitioners argue that the estate could have made payment by borrowing money or by transferring to the petitioners mortgages at

their face value. As already indicated in our earlier discussion this would have required the executors to exercise their discretion, which they never did.

In our opinion the record does not show error in refusing to apply the doctrine of constructive receipt in favor of the petitioners in 1932 or 1940. Accordingly the decisions must be affirmed.

L. HAND, Chief Judge (*dissenting*).

The "constructive receipt" of income is a creation of the Treasury, aimed at preventing taxpayers from selecting the year in which it will be most to their advantage to include in their gross income such items as those here at bar. It is a just corollary of such a doctrine that it shall be applied in favor of taxpayers as well as against them; and we all agree that *Ross* v. *Commissioner*, was right in so holding. Therefore our decision ought not to be different from what it would be, had the taxpayers had no losses in 1932, and had been assessed in that year for the receipt of the sums in question. So far as concerns their commissions, I cannot believe that they could have resisted such an assessment. The surrogate had allowed these to them upon an accounting; and they were administration expenses of the estate. Although there appears to be little authority on the question in New York, such as there is indicates that they are a claim prior to debts, and of course prior to legacies. I agree with my brothers that the law still preserves the fictitious "persona" of the executor, and that it was necessary for these taxpayers, as executors, to draw cheques to their own order as individuals; but that did not give them the privilege of manipulating the date of the receipt at their pleasure; indeed, we have just held the contrary in a situation far stronger for the taxpayer.[1]

Therefore, as soon as they were in funds sufficient to pay the commissions, I think that they "received" them and would have become assessable upon them. I should indeed agree that, if the exercise of their power to take the money involved a possible breach of their fiduciary duty as executors, the power alone would not constitute a "constructive receipt." But of that there was no possibility, if I am right that the commissions had been definitely allowed, and were prior to all other claims. True, it might develop that so to reduce the cash of the estate might later hamper the conduct of the business; and on that account they might have preferred not to press their rights. But they were under no duty not to press them, any more than they were under a duty to contribute to the business out of their personal resources in any other way. Had they urged such a defense against an assessment, the Commissioner could properly have answered that they must be just before they were generous, and must pay their taxes before they created a reserve in favor of creditors or legatees.

The other part of the claims was for interest upon past advances, made by the taxpayers to the estate. These also the surrogate had allowed by decree upon the accounting, in which it must have appeared that there were assets enough to pay all claims in full. It is of course conceivable that the assets had so shrunk that all the debts so allowed could not be paid in full, and it is also possible that after the accounting debts had been incurred in the conduct of the business which had a similar priority. The Tax Court's refusal to accept the testimony as conclusive against these possibilities seems to me to stretch its prerogative

[1] Aramo-Stiftung v. Commissioner, 2 Cir., 172 F.2d 896 (1949).

very nearly to the breaking point; but, as my views are not in any case to prevail, I do not feel myself charged with the duty of deciding whether that refusal was "clearly erroneous." However, if it be further argued that these supposititious expenses of administration also put in doubt whether the commissions remained unconditionally payable, I answer that there must be an end to imaginary obstacles thrown in the path of a taxpayer under the guise of compelling him to prove his case.

Note

In the *Ross* case, cited by the court, it was held that a taxpayer could rely on the doctrine of constructive receipt to defeat the Commissioner's assertion of a deficiency for the year of actual payment, although the amounts in question had not been reported by him in the earlier years, which were now barred by the statute of limitations. The court held that the taxpayer was not estopped or otherwise barred by equitable considerations, partly because there was no misrepresentation of the facts. The amounts in question had been credited to the taxpayer on the books of his employer, which was on the accrual basis, and deducted by it.

> ... [T]he discrepancy between the individual returns and the corporate return was always evident, whether or not it registered on the official consciousness. . . . A mere failure to report income is not a representation that such income has in fact not been received. Inasmuch as the tax incidence of so many transactions is as doubtful as it is, from the mere failure to report income no more significant inference should be drawn than the taxpayer's own interpretation of the law. And it seems settled that estoppel cannot be predicated upon a mere statement of law or silence resulting from an error of law. (169 F.2d 483, 495–6.)

See *infra*, pp. 758–762.

COMMISSIONER v. BOYLSTON MARKET ASSOCIATION

U. S. Court of Appeals, First Circuit, 1942
131 F.2d 966

Before MAGRUDER, MAHONEY, and WOODBURY, Circuit Judges.

MAHONEY, Circuit Judge.

The Board of Tax Appeals reversed a determination by the Commissioner of Internal Revenue of deficiencies in the Boylston Market Association's income tax of $835.45 for the year 1936, and $431.84 for the year 1938, and the Commissioner has appealed.

The taxpayer in the course of its business, which is the management of real estate owned by it, purchased from time to time fire and other insurance policies covering periods of three or more years. It keeps its books and makes its returns on a cash receipts and disbursements basis. The taxpayer has since 1915 deducted each year as insurance expenses the amount of insurance premiums applicable to carrying insurance for that year regardless of the year in which the premium was actually paid. This method was required by the Treasury Department prior to 1938 by G.C.M. 13148, XIII-1 Cum. Bull. 67 (1934). Prior to January 1, 1936, the taxpayer had prepaid insurance premiums in the amount of $6,690.75 and during that year it paid premiums in an amount of $1082.77. The amount of insurance premiums prorated by the taxpayer in 1936 was $4421.76. Prior to

January 1, 1938, it had prepaid insurance premiums in the amount of $6148.42 and during that year paid premiums in the amount of $890.47. The taxpayer took a deduction of $3284.25, which was the amount prorated for the year 1938. The Commissioner in his notice of deficiency for the year 1936 allowed only $1082.77 and for the year 1938 only $890.47, being the amounts actually paid in those years, on the basis that deductions for insurance expense of a taxpayer on the cash receipts and disbursements basis is limited to premiums paid during the taxable year.

We are asked to determine whether a taxpayer who keeps his books and files his returns on a cash basis is limited to the deduction of the insurance premiums actually paid in any year or whether he should deduct for each tax year the pro rata portion of the prepaid insurance applicable to that year. . . .

This court in *Welch* v. *DeBlois*, 1 Cir., 1938, 94 F.2d 842, held that a taxpayer on the cash receipts and disbursements basis who made prepayments of insurance premiums was entitled to take a full deduction for these payments as ordinary and necessary business expenses in the year in which payment was made despite the fact that the insurance covered a three-year period. The government on the basis of that decision changed its earlier G.C.M. rule, *supra*, which had required the taxpayer to prorate prepaid insurance premiums. The Board of Tax Appeals has refused to follow that case in *George S. Jephson* v. *Com'r*, 37 B.T.A. 117; *Frank Real Estate & Investment Co*, ¶ 39,499 P-H Memo TC, and in the instant case. The arguments in that case in favor of treating prepaid insurance as an ordinary and necessary business expense are persuasive. We are, nevertheless, unable to find a real basis for distinguishing between prepayment of rentals . . .; bonuses for the acquisition of leases . . ., commissions for negotiating leases . . ., and prepaid insurance. Some distinctions may be drawn in the cases [citations omitted] on the basis of the facts contained therein, but we are of the opinion that there is no justification for treating them differently insofar as deductions are concerned. All of the cases cited are readily distinguishable from such a clear cut case as a permanent improvement to a building. This latter is clearly a capital expenditure. See *Parkersburg Iron & Steel Co.* v. *Burnet*, 4 Cir., 1931, 48 F.2d 163, 165. In such a case there is the creation of a capital asset which has a life extending beyond the taxable year and which depreciates over a period of years. The taxpayer regardless of his method of accounting can only take deductions for depreciation over the life of the asset. Advance rentals, payments of bonuses for acquisition and cancellation of leases, and commissions for negotiating leases are all matters which the taxpayer amortizes over the life of the lease. Whether we consider these payments to be the cost of the exhaustible asset, as in the case of advance rentals, or the cost of acquiring the asset, as in the case of bonuses, the payments are prorated primarily because the life of the asset extends beyond the taxable year. To permit the taxpayer to take a full deduction in the year of payment would distort his income. Prepaid insurance presents the same problem and should be solved in the same way. Prepaid insurance for a period of three years may be easily allocated. It is protection for the entire period and the taxpayer may, if he desires, at any time surrender the insurance policy. It thus is clearly an asset having a longer life than a single taxable year. The line to be drawn between capital expenditures and ordinary and necessary business expenses is not always an easy one,

but we are satisfied that in treating prepaid insurance as a capital expense we are obtaining some degree of consistency in these matters. We are, therefore, of the opinion that *Welch* v. *DeBlois, supra,* is incorrect and should be overruled.

The decision of Board of Tax Appeals is affirmed.

Note

1. If the taxpayer had bought and paid for a three-year's stock of materials or supplies, he might have been required to inventory them, thus restricting his deduction for the current year to the amount actually consumed then, if this procedure was necessary to prevent a distortion of income See Regs. 118, Sec. 39.23(a)–3. In *Fackler* v. *Commissioner,* 39 B.T.A. 395, 398 (1939), a taxpayer was allowed to deduct in the year of payment prepaid interest on a mortgage. The court said:

> . . . distortion of the petitioner's income would not result here from the deduction of this prepaid interest payment any more than it would from the payment in one of the current taxable years for interest covering an elapsed period of more than those years.

The *Fackler* case has been accepted by the Bureau, I.T. 3740, 1945 C.B.109, and its principle is also applied to the prepayment of taxes, *Glassell* v *Commissioner,* 12 T.C. 232 (1949). Note that §§ 163 and 164 allow the deduction of taxes and interest "paid or accrued within the taxable year." Section 162(a) allows "ordinary and necessary expenses paid or incurred during the taxable year" to be deducted. Do these sections afford a statutory basis for distinguishing between prepaid insurance and prepaid interest or taxes? If the taxpayer in the *Boylston Market Association* case had paid the total premium at the end of the three-year period, could he have deducted the full amount in that year? Is there any restriction on the right of a cash basis taxpayer to postpone payments in order to take deductions in advantageous years?

2. It has been held that the cash basis taxpayer does not get a deduction when he gives his note for a deductible expense, even if the note is taken as payment of the debt. *Helvering* v. *Price,* 309 U.S. 409 (1940). On the other hand, the giving of a check fixes the time of deduction if the check is subsequently honored. See *Estate of Spiegel* v. *Commissioner,* 12 T.C. 524 (1949), although directly concerned with the meaning of "payment" under § 170, the opinion is equally applicable to other deductions by cash basis taxpayers.

3. A corporate taxpayer on the cash basis credited certain salaries to its two principal officers and stockholders under circumstances requiring them to report the salaries as constructively received. In *Vander Poel, Francis & Co., Inc.* v. *Commissioner,* 8 T.C. 407 (1947), a divided court held that the salaries could not be deducted by the employer until paid by it; the court refused to accept a doctrine of "constructive payment" as a corollary to constructive receipt. If dividends have been credited by a corporation to the account of a stockholder so as to be constructively received by him, however, they are apparently "paid" for purposes of computing the "dividends paid" credit of § 561, which is available in determining the personal holding company and § 531 surtaxes. Regs. 118, Sec. 27(b)–2(a)(4), see *International Bedaux Co.* v. *Commissioner,* 17 T.C. 612, 619 (1951).

3. The Accrual Method

GEORGIA SCHOOL-BOOK DEPOSITORY, INC. v. COMMISSIONER

Tax Court of the U. S., 1943
1 T.C. 463

KERN, Judge: The question is whether petitioner, which was on an accrual basis, should have accrued certain school book commissions at the time the books

were sold by the publishers to the state, or should have returned them as income only when the books were paid for by the state, as petitioner contends.

Petitioner was a broker which received an 8 per cent commission on all school books purchased by the State of Georgia through it. For this commission it performed certain services of advantage to both parties, such as executing the contracts of the state board of education with various publishers, taking care of the books as a central depository until final distribution, seeing that enough were on hand to meet the state's demands, distributing them, and collecting the moneys in payment from the state and holding them in trust until paid over to the publishers. It was responsible for the return in salable condition of any books not used. It had no title to the books at any time, and (except in the case of one publisher) posted a bond with each publisher to guarantee performance of its duties. Petitioner also carried on a somewhat similar business as a book broker of college books not on the state list and under these contracts was responsible for the collection of all accounts.

Petitioner did not accrue its commissions on the state books but did accrue its commissions on the college books at the same time that its liability for the books to the publishers was accrued. Under the contracts for state school books it was provided that petitioner should receive its brokerage "at the time of settlement" and this term is explained by the provision that the petitioner shall make quarterly reports "so as to show the exact balance due" the publisher by the petitioner, and shall remit "its *pro rata share* of all cash received from the collection of warrants issued by the State of Georgia for books sold to the state when and as such warrants are received."

The publishers could look for payment from the state, and, consequently, petitioner could look for its commissions only from the "Free Textbook Fund," which was renewed only from the excise laid on beer.* During the taxable years 1938 and 1939 this fund was insufficient to pay the petitioner in full. The state, in its accounting, did not treat these large deficits as present liabilities except to the extent that funds were already on hand to meet them, the remainder being considered an encumbrance on the textbook fund in the next year. The "accounts ripen," the auditor reported, "for payment when and as funds become available in the Textbook Fund."

Petitioner contends, first, that the brokerage was not earned until payment, and, secondly, that there was no reasonable expectancy that payment ever would be made; and for these reasons, it urges its ultimate contention that the commissions here involved were not properly accruable in the respective taxable years.

* On March 4, 1937, the State of Georgia enacted a Free Textbook Act, under which the state board of education was directed to inaugurate and administer a system of free textbooks for the public schools of Georgia, and to execute contracts therefor. The act provides that the cost of administering the free textbook system and purchasing the books shall be paid by the state from such funds as may be provided by the General Assembly for that purpose, ... The Legislature thereupon created a free textbook fund, made up solely from excise taxes on the sale of malt beverages in the state. The act provides that funds derived from taxes on malt beverages shall be apportioned as follows: Not over 3 percent shall be paid to the revenue commission for enforcing the malt beverage act and "the remainder shall be set aside and devoted for the support of the common schools of the state and used for the purpose of furnishing free textbooks to the children attending the common schools", any excess to be used for other school purposes. . . .

In so far as appears, all acts which were required of petitioner to earn its brokerage, save one, had been done in the taxable year. It had received the books from the publishers, stored them, and later distributed them to the several schools. All it had not done was to receive the money from the state and pay it out to the publishers. On this account the actual payment of the brokerage may not have been due to petitioner until this money was received, but the right to it had accrued by the performance of its duties. *United States* v. *Anderson* 269 U.S. 422. It is the *right* to receive money which in accrual accounting justifies the accrual of money receivable and its return as accrued income.

The Supreme Court said in *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182 (p. 184):

> . . . Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. . . .

The receipt of the money from the state, the deduction of petitioner's commission, and the transmission of the balance to the publishers were the least of its duties and can not be made the criterion of the arisal of the right. Paragraph 9 of the contract assumes that the publisher's right to payment had arisen, for it requires that the quarterly reports which petitioner was to submit should "show the exact balance due the first party by the second party [petitioner] . . ."

. . .

We pass, then, to the second question, whether there was a reasonable expectancy that the claim would ever be paid. Where there is a contingency that may preclude ultimate payment, whether it be that the right itself is in litigation or that the debtor is insolvent, the right need not be accrued when it arises. This rule is founded on the old principle that equity will not require a suitor to do a needless thing. The taxpayer need not accrue a debt if later experience, available at the time that the question is adjudged, confirms a belief reasonably held at the time the debt was due, that it will never be paid. *Corn Exchange Bank* v. *United States*, 37 Fed.(2d) 34 (2d Cir.); *H. Liebes & Co.* v. *Commissioner*, 90 Fed.(2d) 932 (9th Cir.), and cases there cited at page 937. On the other hand, it must not be forgotten that the alleviating principle of "reasonable expectancy" is, after all, an exception, and the exception must not be allowed to swallow up the fundamental rule upon which it is engrafted requiring a taxpayer on the accrual basis to accrue his obligations, *Spring City Foundry Co.* v. *Commissioner*, *supra*. If this were so, the taxpayer might at his own will shift the receipt of income from one year to another as should suit his fancy. *Cf. Clifton Manufacturing Co.*, 1 T.C. 71. To allow the exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable. Postponement of payment without such accompanying doubts is not enough. . . .

Applying these principles to the instant case, we must conclude that, despite the condition of the treasury of the State of Georgia when the free schoolbook fund was inaugurated and for several years thereafter, there was no reasonable expectation that the sums owed by the state to petitioner's publishers and, con-

sequently, the commissions to petitioner itself, would not ultimately be paid. It would naturally take a few years to establish in full working order a system of such magnitude, but a comparison of the two years before us shows that Georgia was gradually reducing its schoolbook obligations. Georgia is a state possessing great resources and a fine record of fiscal probity, and undoubtedly it can and will meet its obligations. The fact that petitioner, on behalf of its principals, continued to sell and deliver school books to the state indicates that there was no serious doubt as to the ultimate collection of the accounts here involved.

We conclude, therefore, that petitioner's commissions on all books purchased by the state through it in the taxable years should have been accrued and returned as income in those years.

Judgment will be entered for the respondent.

Note

1. Holland, "Accrual Problems in Tax Accounting," 48 *Mich. L. Rev.* 149 (1949), considers the extent to which the accrual of an account receivable or payable may be unwarranted because:

> (1) the existence of any liability at all may be uncertain; (2) the liability may be contingent because its existence depends on the happening of a future contingent event, (3) both the taxpayer and a third party may claim the right to receive the payment; (4) the amount to be received or paid may be uncertain; or (5) the obligation may not appear collectible.

May a taxpayer accrue an expense item if, by reason of his unsound financial condition, it is doubtful whether he will ever be able to pay the item? *Cohen* v. *Commissioner*, 21 T.C. No. 99 (1954).

2. *Pacific Grape Products Co.* v. *Commissioner*, 17 T.C. 1097 (1952), involved the question of when an accrual basis taxpayer should accrue as income amounts for which it billed its customers for goods to be shipped at later dates. On the billing dates the goods (canned fruits) were not labeled, segregated, or identified as subject to the contract of any particular customer. The court held that the income was to be accrued when title to the goods passed, and it found that while the canning industry may have construed an industry-wide standard contract as passing title to the buyers on the billing date, there was no evidence that the buyers so understood the contract. In the absence of such evidence, it concluded that title did not pass (whether the goods were regarded as fungible or not) on the billing dates, and that the income was not to be accrued when the customers were billed. (Presumably the proper time, in the court's view, was the date of shipment.) Judge Opper, with whom five other judges joined, dissented:

> The practice of disapproving consistent accounting systems of long standing seems to me to be exceeding all reasonable bounds. . . . Methods of keeping records do not spring in glittering perfection from some unchangeable natural law but are devised to aid business men in maintaining sometimes intricate accounts. If reasonably adapted to that use they should not be condemned for some abstruse legal reason, but only when they fail to reflect income. There is no persuasive indication that such a condition exists here. On the contrary, a whole industry apparently has adopted the method used by petitioner. (17 T.C. 1097, 1110–11.)

3. When should an accrual basis taxpayer have reported the income involved in the *Amend* and *Weil* cases, *supra*, p. 653 and 657?

4. Just as the accrual basis taxpayer must report income when it accrues, even though it has not yet been received in cash or property, so he must deduct expenses when they are incurred, even though payment is postponed. But although §§ 162(a),

163(a), and 164(a) permit the deduction of items "paid *or incurred*" or "paid or *accrued*" in the taxable year, certain other sections of the Code allow items to be deducted only if they have been "paid." Thus, § 170(a)(1) permits the deduction of a "charitable contribution . . . payment of which is made during the taxable year"; § 403(a) permits the deduction of contributions "paid" by an employer under certain employee benefit plans, §§ 71(a) and 215(a) require the wife to include and permit the husband to deduct alimony "payments", § 213(a) allows medical expenses "*paid* during the taxable year" to be deducted; and § 561(a) allows a credit (available in computing the personal holding company and § 531 surtaxes) for "dividends *paid* during the taxable year." Is there any reason why accrual basis taxpayers should be required to employ a cash basis for these items?* See also Regs. 118, Sec. 115(a)–1(d), providing that a dividend is taxable to shareholders "when the cash or other property is unqualifiedly made subject to their demands" It has been held that this regulation requires accrual basis taxpayers to report dividends as of the payment date rather than on the record date, thus placing them on a parity with cash basis taxpayers. *Commissioner* v. *American Light & Traction Co.*, 156 F.2d 398 (7th Cir. 1946).

It has been held that an amount was "paid" by an accrual basis taxpayer when it gave a negotiable demand note to the obligee. *Sachs* v. *Commissioner*, 208 F.2d 313 (3d Cir. 1953). The *Price* case, *supra*, p. 663, denied a deduction to a cash basis taxpayer who gave a note, but the opinion does not indicate whether the instrument was payable on demand and negotiable.

5. Section 267(a)(2) might be examined at this point. It finds its principal application when a closely-held corporation is on the accrual basis and a dominating stockholder on the cash basis, the corporation cannot deduct accrued salary and interest owing to the individual in question if the amounts are not paid in the taxable year or within two and one-half months thereafter. Why should the corporation's deduction be denied in such circumstances? See Paul, "Some Problems Under the New Section 24(c)," 32 *Taxes* 191 (1954).

SOUTH TACOMA MOTOR CO. v. COMMISSIONER

Tax Court of the U. S., 1944

3 T.C. 411

The sole question presented is whether the proceeds received by petitioner, who was on the accrual basis of accounting, from the sale of certain coupon books, each one of which contained an agreement which provided for specified services to be rendered by petitioner to its customers over a period not necessarily limited to the taxable year, are includible in petitioner's gross income for the taxable year in which such sales were made without regard to the amount of service performed thereunder, or whether only so much of the proceeds from these sales is to be included in petitioner's gross income in a particular taxable year as is represented by the actual performance by petitioner during that particular taxable year of the services specified in the agreement. . . .

Findings of Fact

Petitioner has maintained its accounting records on an accrual basis for many years, including 1939 and 1940.

Petitioner is in the business of selling new and used automobiles and operating

* Under § 170(a)(2), an accrual basis taxpayer may elect to deduct charitable contributions in the year of accrual if payment is made in the first two and one-half months of the following year; and there is a somewhat similar provision in § 404(a)(6) for contributions to employee benefit plans. § 563 allows certain dividends paid after the close of the taxable year to be treated as though they had been paid during the year.

a repair shop and service station in connection therewith. During 1939 and 1940, in addition to selling products of General Motor Sales Corporation (hereinafter sometimes referred to as General Motors) and its subsidiaries, petitioner sold service and chassis lubricating coupon books designated "Chevrolet Owners Protective Service." The method of selling these books was originated by General Motors Corporation. Such a book containing six coupons sold for $5, and a similar book containing twelve coupons sold for $10. . . .

The purchase price for each book is paid in full upon the issuance of the book. The services called for in a coupon book are usually spread over a period of time which may vary from several months to several years.

Petitioner did not report the receipts from sales of the coupon books as gross income in the taxable year in which they were sold, but instead credited the receipts therefrom to its service account. Subsequently, when a customer presented a coupon in payment for service and when the service specified by a coupon was performed, petitioner then charged the service account with 83 cents, the selling price allocable to each coupon, and credited 83 cents to gross income on its books. The portion of the sale price of the coupon books for which no service had yet been performed was reflected by petitioner on its monthly financial statement as a liability.

The cost of performing the various services (labor and materials) was charged to expense in the year the service was rendered. Such costs were subject to variance due to fluctuation of the costs of labor and materials at the time the services were actually performed.

It was petitioner's practice to redeem the unused portion of these coupon books if the customer disposed of his car, or moved to another community, or even if the customer was merely dissatisfied with the service or wanted to cash the unused coupons. This practice was known to petitioner's customers. If a refund was made to a customer, petitioner would recompute the charges made for past services rendered and charge at the rate of $1 per lubrication instead of at the discount rate of 83 cents per lubrication. If a customer failed to call for services, petitioner, after a reasonable time, would credit income with the unused portion of the sale price of the coupon book. . . .

The money received by petitioner from the sale of the coupon books became part of the general funds and assets of petitioner and was kept in the corporation's general bank account, the balance of which always exceeded the amount of money equivalent to the value of the unused coupons in these books. . . .

Petitioner made its monthly financial statement to General Motors on a form supplied by the latter. The item, "Service Contract Deposits," was listed on page 1 of that form under "Liabilities."

The method of accounting used by petitioner is required by its contract with General Motors. The petitioner followed the instructions set forth in the General Motors accounting manual and treats the service account as a current

DISNEY, Judge: During each of the taxable years in question, petitioner re-
liability. . . .

OPINION

ported as gross income from the sales of the coupon books described in the facts above only that part of the proceeds therefrom which was represented by the actual performance by petitioner during the particular taxable year of the services specified in the agreement. Petitioner carried the balance of the proceeds on its books of account as a liability.

Petitioner contends that his method of accounting and of reporting income from the sales of the coupon books is entirely consistent with the following applicable provisions of the Internal Revenue Code:

Section 41*, Internal Revenue Code, providing in part as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . .

Section 42,† Internal Revenue Code, providing in part as follows:

> The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. . . .

Respondent, relying on the same sections of the Internal Revenue Code, has determined that all the proceeds received in a particular taxable year from the sales of these coupon books should be included in petitioner's gross income for that taxable year, irrespective of whether petitioner performed any services during that taxable year pursuant to the sales agreements.

Petitioner makes two principal contentions to sustain its position: (1) The customer has the right to rescind the contract and receive a refund after the taxable year in which the coupon book was sold; and (2) the nature of the contract is such that petitioner will have to perform many of the services required by the contract subsequent to the taxable year in which the coupon book was sold.

The first of these contentions must be rejected on the authority of *Brown* v. *Helvering*, 291 U.S. 193, wherein it is pointed out that "the mere fact that some portion of it [the money received by the taxpayer] might have to be refunded in some future year in the event of cancellation . . . did not affect its quality as income." Either party to the insurance contracts there considered had the right of cancellation, as the Court points out. See also *Grauman's Greater Hollywood Theatre, Inc.*, 37 B.T.A. 448; *Automobile Underwriters, Inc.*, 19 B.T.A. 1160. In *Pioneer Automobile Service Co.*, 36 B.T.A. 213, where the petitioner sold automobile service contracts, we approved the inclusion of the sales price in income in the year of sale and disapproved the idea of a reserve for expenses.

The second contention must also be overruled on the authority of *South Dade Farms, Inc.* v. *Commissioner*, 138 Fed.(2d) 818, wherein the court states that "section 41 . . . required that the method of accounting should clearly reflect income, not net earnings." The petitioner received its income in the taxable year, though its net earnings therefrom might be affected in a later year.

* See §§ 441(a)-(c) and 446(a)-(b) of the 1954 Code. [Ed.]

† See § 451(a) of the 1954 Code. [Ed.]

Petitioner cites as authority for its method of reporting the proceeds received from the sales of the coupon books the case of *Clinton Hotel Realty Corporation* v. *Commissioner*, 128 Fed. (2d) 968. That case is distinguishable from the instant case because the alleged advance payment of rent in that case was provided by the lease as "security" or as a "deposit" for the payment of rent and the performance by the lessee of the various other covenants in the lease. The court in that case pointed out that "if the only agreement was that it should apply to the last year's rent, it would of course be rent paid in advance" and therefore includible in the taxpayer's gross income for the year in which received. *Cf. Edwin B. DeGolia*, 40 B.T.A. 845. The facts in the instant case are in closer analogy to the case of *Astor Holding Co.* v. *Commissioner*, 135 Fed. (2d) 47, wherein the court, in holding that an amount paid to a lessor as rent in advance is taxable income in the year of receipt, distinguished *Clinton Hotel Realty Corporation* v. *Commissioner*, *supra*, and stated that "whether a payment falls into one category or the other depends on the facts of the particular case."

Petitioner also cites *Bonded Mortgage Co. of Baltimore* v. *Commissioner*, 70 Fed. (2d) 341, as authority for the general proposition that both sides of petitioner's "ledger must be treated alike; otherwise its true income will not be reflected by the accounting." Relying upon this general proposition, petitioner argues that, since it is permitted to deduct expenses only in the year in which they are incurred, *Stern Bros.*, 13 B.T.A. 1192, it follows that it should be permitted to postpone the inclusion of the proceeds from the sale of these coupon books to the year in which it incurs expenses in performing the services called for in the coupon books. In the *Bonded Mortgage Co.* case, the Commissioner sought to require the taxpayer to include all the commissions received by it on mortgage loans in its gross income for the year of receipt, and at the same time denied the taxpayer the right to deduct all its expenses incurred during that same year in carrying on its business, such as bankers' commissions on the company's bonds or notes sold and annual premiums to the surety company which guaranteed the mortgages. The Commissioner contended that these expenses should be prorated over the life of the bonds or notes. The court held that the taxpayer could deduct these expenses in the year in which they were incurred without proration. In the *Bonded Mortgage Co.* case, the taxpayer incurred the expenses in the same year he received the income; the question there was whether it was proper to require the taxpayer to prorate expenses where income was not prorated. In the instant case, as far as the portion of the proceeds which are here in question is concerned, petitioner admits it did not incur any expenses with reference thereto in the year of their receipt; therefore, no question similar to that in the *Bonded Mortgage Co.* case arises.

When petitioner in the instant case sold and was paid for a coupon book an unilateral contract resulted and petitioner's right thereunder to use the proceeds was absolute. It was under no restriction, contractual or otherwise, as to their disposition, use, or enjoyment. The possibility of being required to make refunds in the future constitutes no such restriction. *Brown* v. *Helvering*, *supra.* Refunds were made in *South Dade Farms, Inc.* v. *Commissioner*, *supra.* Petitioner did not maintain a separate fund for these proceeds; they were kept in petitioner's general bank account. These proceeds were not loaned to petitioner (as petitioner contends in citing *Summit Coal Co.*, 18 B.T.A. 983); they were

not merely deposited with petitioner for safekeeping, they were not security for the performance by the customer of any term of the contract; nor were they held by petitioner upon an express or resulting trust. The fact that petitioner has been on an accrual basis of accounting for many years, including the taxable years in question, is not controlling. *C. H. Mead Coal Co.*, 31 B.T.A. 190, 192; *E. B. Elliott Co.*, 45 B.T.A. 82, 86.

Since petitioner's method of accounting did not treat the proceeds received from the sale of these coupon books as income in their entirety in the taxable year in which they were received, it follows that petitioner's method of accounting did not clearly reflect its income and that, therefore, the respondent's determination must be sustained.

Decision will be entered for the respondent.

Note

1. Brown v. *Helvering*, cited by the Court, involved a general insurance agent who was entitled to receive commissions on all insurance policies written by its sub-agents. The commissions were reported in the year the policies were written, and a deduction (estimated on the basis of past years) was taken for the commissions that, on the basis of experience, would probably have to be refunded to the companies in the event that some of the policies were cancelled by the holders. The Supreme Court denied the deduction:

> In respect to no particular policy written within the year could it be known that it would be cancelled in a future year Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties. This is shown by the variations in the percentages in the several five-year periods of the aggregate of refunds to the aggregate of overriding commissions (291 U.S. 193, 201 (1934).)

Did the deduction for which the taxpayer contended, so far as predictability or susceptibility to abuse was concerned, differ materially from an addition to a reserve for bad debts, permitted by § 166(c)?

2. Section 452 of the 1954 Code was enacted for the express purpose of dealing with the problem illustrated by the *South Tacoma Motor Co.* case. How would the disputed income be reported if an election were made under § 452? Could the Commissioner authorize a cash basis taxpayer to account for prepaid income in a similar fashion under § 446(c)(4)?

3. See Regs. 118, Sec. 39.42–5, permitting taxpayers who issue trading stamps or coupons redeemable for merchandise to deduct an amount that, in the light of experience, will be required to redeem the stamps or coupons. *Grolier Society, Inc.* v. *Commissioner*, ¶ 53,304 P-H Memo TC, involved a taxpayer who sold encyclopedias and issued to each buyer 100 coupons, each entitling the buyer to submit a question for research and reply. The court implied that the estimated cost of answering these questions could be accrued under the regulation dealing with trading stamps, but denied the deduction because the information called for by the regulation was not supplied. See also § 832(b)(4), permitting certain insurance companies to exclude unearned premiums from income.

4. In *Booth Newspapers, Inc.* v. *Commissioner*, 17 T.C. 294 (1951), aff'd. 201 F.2d 55 (6th Cir. 1952), the court held that a cash basis taxpayer was taxable in the year of receipt on the full amount received for prepaid newspaper subscriptions. In I.T. 3369, 40–1 C.B. 46, the Bureau ruled that accrual basis taxpayers could either report prepaid subscriptions in full or could spread prepaid subscriptions and the expenses

allocable thereto over the subscription period. The ruling contains no discussion of the legal or accounting issues.

VEENSTRA & DE HAAN COAL CO. v. COMMISSIONER

Tax Court of the U. S., 1948
11 T.C. 964

KERN, Judge: As a result of the wartime conditions prevailing in 1943, petitioner, which was engaged in the business of buying coal and coke at wholesale and selling these commodities at retail, desired to have its customers indicate their needs in advance and was able to obtain deposits from its customers to be applied on the price of coal and coke to be charged by petitioner when and if the coal and coke was sold and delivered to them. As of December 31, 1943, petitioner had on hand the amount of $11,380.93 representing the balance of deposits made in 1943 which either was applicable on the sale prices to which it might be entitled by reason of sales and deliveries to be made in 1944, or was refundable to customers by reason of its inability to obtain coal and coke for sale to them. As of that date petitioner did not know whether it would be able to fill all the orders on which deposits had been made. Neither did it know what the wholesale price of coal and coke would be, nor did it know what the retail price of coal and coke would be at the time of sale and delivery to the customers. As of that date it had on hand only a small amount of coal and coke. Thus, the amount of deposits on hand at the end of the year was conditionally held by petitioner against future performance by it of contingent executory contracts to sell. Respondent determined "that the amount of $11,380.93 received during the taxable year 1943 is includible in your gross income for said taxable year."

Income subject to tax under the Sixteenth Amendment to the Constitution, and designated as taxable in section 22(a) of the Internal Revenue Code, may be gross income not subject to deductions granted as a matter of legislative grace; but gross receipts are not equivalent to gross income. See *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179; *Southern Pacific Co.* v. *Lowe*, 247 U.S. 330. It is axiomatic that a receipt of capital or a return of capital does not constitute taxable income. In the usual sale of property the price is paid by the vendee at the time of or after the sale and the delivery of (or a passing of title to) the property sold. In such a case the gross income derived by the vendor from the transaction is the excess of the purchase price over his cost or other basis to the property, and the usual problem is whether the payments, when received, should "be attributed in their entirety to capital until it is fully returned, the excess thereafter being treated as income," or whether a part of each payment should be considered as a return of capital and the remainder considered as taxable gross income. See Mertens, *Law of Federal Income Taxation*, § 5.07. In some cases involving contracts to sell property, even specific property, at a specific price,[1] an amount is paid to the vendor before the sale to be applied on the purchase price, contingent upon the consummation of the sale upon stated conditions. In

[1] "Contracts to sell" as distinguished from "Contracts of sale" or "Sales in praesenti" are executory contracts intended to pass title to goods from the vendor to the vendee at some future time. See sec. 1, Uniform Sales Act; Comp. Stat. New Jersey, 1910, pp. 4647–4665.

those cases the gain from the sale, *i. e.*, the excess of price over basis, has been held to be gross income in the year when the sale is consummated, and not in the year when the contract was executed and the "advance payment" was made. See *Sophia M. Garretson*, 10 B.T.A. 1381; *Consolidated Utilities Co.* v. *Commissioner*, 84 Fed. (2d) 548. The reason for this is obvious: In the case of sales of property the gross income of the vendor is the gain derived from the sale, and until the sale is made, there is no gain. As the Court said in *Consolidated Utilities Co.* v. *Commissioner*, *supra*, ". . . the statute taxes gains from sales, not estimated gains from contracts to sell . . ." Not until the transaction of sale is a closed one will a gain arise which will constitute gross income to the vendor. See *Burnet* v. *Logan*, 283 U.S. 404.

In the instant case the contracts between petitioner and its customers were executory and contingent contracts to sell unascertained, not specific, goods, at an unspecified price, which were to be acquired, if possible, by petitioner at a cost unknown to it at the time the contracts were executed. At the end of the taxable year, the contracts, in so far as the deposits here at issue were concerned, were still executory, were still contingent upon petitioner's obtaining coal and coke, were still contracts to sell unascertained goods at an unspecified price, and, except for a small amount of goods on hand, were contracts to sell goods which were to be acquired at a cost unknown and unknowable by petitioner. Even if "estimated gains from contracts to sell" constituted gross income subject to tax, no possible way has been suggested by respondent, and none occurs to us, by which the gain from the petitioner's contracts to sell could be estimated as of December 31, 1943. Under the facts presented by the record, we are of the opinion that respondent's determination that the entire amount of the deposits on hand as of that date constituted gross income to petitioner in 1943 is not only erroneous, but is also arbitrary within the rule of *Helvering* v. *Taylor*, 293 U.S. 507.

Respondent's determination is probably due to a misconception of such cases as *South Tacoma Motor Co.*, 3 T.C. 411; *Your Health Club, Inc.*, 4 T.C. 385, *National Airlines, Inc.*, 9 T.C. 159; and *Capital Warehouse Co.*, 9 T.C. 966, upon which he relies on brief. Those were cases in which payments were made in advance for personal services, and the transactions were closed in the several taxable years in which the payments were made. The advance payments in those cases constituted gross income when received, and the fact that deductions might be accrued or paid in a subsequent year when the services, or a part of them, were rendered, did not prevent the inclusion of the payments in taxable income for the year when they were received. In the instant case the transactions were executory contingent contracts for the sale of unascertained goods, and they were in no sense closed transactions. The deposits made incident to these transactions would be gross income only if they represented gains from closed and completed sales, or at least from contracts of sale. Since they were not gains from such sales, they were not gross income, and, therefore, were not taxable to petitioner in 1943.

From the practical standpoint, the deposits made with petitioner by its customers in advance of sales were equivalent to a forced temporary advance by the customers to petitioner's working capital. By reason of conditions prevailing in 1943 petitioner, instead of buying coal and coke at wholesale with its own capital

and then selling at retail to its customers, thus recovering its capital plus a realization of profit, arranged, in effect, for its customers to advance the capital with which it purchased the coal and coke at wholesale. In this analysis the facts are not unlike those in *Summit Coal Co.*, 18 B.T.A. 983. As in that case, the advances or loans of capital repayable by deliveries of coal did not constitute gross taxable income in the year in which its advances or loans were made, but, as we said in the cited case, p. 988, "these advances became income to petitioner only as and when recoupment was made from deliveries."

The issue presented is decided in favor of petitioner. In view of the fact that another adjustment in petitioner's tax liability for the taxable year has been made by respondent and is not here in issue.

Decision will be entered under Rule 50.

HARROLD v. COMMISSIONER

U. S. Court of Appeals, Fourth Circuit, 1951
192 F.2d 1002

Before PARKER, SOPER and DOBIE, Circuit Judges.

SOPER, Circuit Judge.

These are petitions to review orders of the Tax Court involving income tax for the year 1945, upholding the Commissioner of Internal Revenue's disallowance of a deduction of $25,210.18, and asserting a deficiency against taxpayer Harrold in the amount of $12,935.95 and taxpayer Cromling in the amount of $11,458.04

During the taxable year and prior thereto, the taxpayers were partners doing business under the firm name of Cromling & Harrold and were engaged in the mining of bituminous coal from leased lands by the strip mining method. This is a process whereby the soil or overburden is removed so that the coal can be mined with shovels. The partnership kept its books and filed its federal income tax returns on the accrual basis.

In 1945 the partnership removed coal by the strip mining method from 31.09 acres of land in West Virginia held by it under five leases and contracts which required it to conduct the mining operations in conformity with the laws of West Virginia and of the United States, and to restore and replace the surface in compliance with provisions of pertinent laws of West Virginia. Before starting mining operations on the leased lands, the partnership obtained strip mining permits as required by the laws of West Virginia, and posted penal bonds with the state to insure faithful performance of its statutory obligation to refill the lands. The contractual and statutory obligation on the partnership to "backfill" required it to put the soil back the way both the state and the lessor farmers wanted it. It was necessary to fertilize and replant the land with grass, shrubs or clover before the Department of Mines of West Virginia would release the bonds.

At the end of 1945 the tract of 31.09 acres had been completely stripped and the coal had been removed; and the obligation of the partners to refill had become fixed and definite. Paul Harrold, one of the partners, had been actively engaged in strip mining and back-filling lands in West Virginia for sixteen years. Based on this experience the firm estimated in 1945 that the cost of the refill in this instance would amount to $1,000 per acre, but since the firm was using its equipment in

stripping operations elsewhere it postponed the refilling until 1946, and in accord with sound accounting practice set up a reserve on its books for the accrued expense involved in the sum of $31,090 and deducted the same as an expense of the business in its federal income tax for 1945.

The process of back-filling was commenced in the spring of 1946, when the weather became favorable, and was completed during 1946 at a cost of $25,210.18 or $5,879.82 less than estimated and accrued. Accordingly the partnership reduced the 1945 accrual on its books, and, on January 6, 1947, filed an amended partnership return for the taxable year 1945, reducing the estimated deduction to the actual cost of back-filling the land.

The Tax Court, conceding that it was the practice of prudent business men to set up reserves to cover contingent liabilities, nevertheless held that deduction from income in 1945 could not be allowed because the liability which it represented was not fixed and certain, but was based merely on an estimate of the future cost of the work. In support of this conclusion it pointed out that the cardinal rule in the federal income tax system is that net income must be computed and taxed on an annual basis so as to provide revenue to the government at regular intervals; and hence neither income nor deduction may be accelerated or postponed from one taxable year to another in order to reflect the ultimate result of a business transaction; and this principle must be observed, even though the allocation of an indefinite obligation to the taxable year in a given instance would seemingly work a more equitable result to the government or the taxpayer. *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 363, 51 S. Ct. 150, 75 L. Ed. 383; *Brown* v. *Helvering,* 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725.

Accordingly it is established that deductions may be taken on an accrual basis only in the year in which the taxpayer's liability to pay has become fixed and certain; and in some decisions, notably *Security Flour Mills Co.* v. *Com'r,* 321 U.S. 281, 286-287, 64 S. Ct. 596, 88 L. Ed. 725, and *Dixie Pine Products Co.* v. *Com'r,* 320 U.S. 516, 519, 64 S. Ct. 364, 88 L. Ed. 420 it has been said that unless the amount as well as the fact of liability has become final and definite in the year in in which the accrual is claimed, the deduction must be allowed only in the year in which the payment actually takes place. It is true that in these cases the court was concerned with the existence rather than the amount of the liability; but in other decisions uncertainity of the amount alone has been held enough to bar the accrual of the expense in the year in which the liability therefor has become established. Thus in *Spencer, White & Prentis v. Com'r,* 2 Cir., 144 F.2d 45, a contractor, under an obligation to restore certain structures in the streets of New York which had been disturbed or destroyed in the construction of a subway, was not allowed to accrue the estimated cost of restoration in a tax year prior to the doing of the work; and in *Capital Warehouse Co. v. Com'r,* 8 Cir., 171 F.2d 395, a warehouseman, who collected from customers upon the receipt of goods for storage, a charge for the removal of the goods subsequently to take place, was not allowed to accrue in advance the cost of the removal operation based on the experience of other warehousemen, that 60 per cent of the cost should be allocated to the expense of handling out and 40 per cent to the expense of handling in, owing to the fact that merchandise usually came into the warehouses in carload lots and left in less than carload lots. The experience of the taxpayer, however, differed in that in its case the merchandise was shipped out in carload lots.

There is no material distinction between *Spencer, White & Prentis* v. *Com'r*, *supra*, and the pending case unless it be that in the former an approximate estimate of the cost of the work of restoration, considering the number and unusual character of the items involved, could not be easily arrived at before the work was undertaken. In any event, we think that the ability to make an approximate estimate should be the determining factor in each case, rather than the literal application of the formula that an asset or a liability may not be accrued in any taxable year prior to its liquidation, unless both the existence and the amount thereof is fixed and certain.

As to the need for the existence of a definite asset or liability to justify an accrual in the taxable year, there can be no doubt as many decisions attest, *Lucas* v. *American Code Co.*, 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150, 75 L. Ed. 383; but it has not been deemed essential that the amount of an accrued liability shall have been definitely ascertained to justify deduction from income in the taxable year. Confessedly, it is enough if the facts from which the amount can be calculated had then occurred and are later ascertained, or as Judge Learned Hand puts it in *Uncasville Mfg. Co.* v. *Com'r*, 2 Cir., 55 F.2d 893, 895, if the computation, although unknown, is not unknowable at the end of the year. Such was the situation before the court in *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 52 S. Ct. 529, 76 L. Ed. 1111, where the amount of a government award was not ascertained until 1923, but it was held that the right of the taxpayer thereto having ripened in 1920, it should have been returned in an estimated amount as part of the income for that year. To the same effect was the decision of this court in *Baltimore & Ohio R. Co.* v. *Com'r*, 4 Cir., 78 F.2d 456.

Again it has been held that a liability may be accrued as a fixed obligation on the taxpayer's books and taken as a deduction from income when it is definitely incurred, although it is known at the time that the amount may be diminished by subsequent events. *American National Co.* v. *United States*, 274 U.S. 99, 47 S. Ct. 520, 71 L. Ed. 946; *Ohmer Register Co.* v. *Commissioner*, 6 Cir., 131 F.2d 682, 143 A.L.R. 1164.

It is not suggested that the pending case falls precisely within either of the two categories last described. They serve to show, however, that the accrual of the approximate amount of an item that comes into existence in a taxable year to be followed by appropriate adjustments when the precise amount is ascertained, is not deemed impracticable by the taxing authorities or inconsistent with the principle that income and outgo must be computed and taxed on an annual basis. Moreover, decisions of the courts, including the Tax Court itself, furnish examples of the allowance of a reasonably accurate estimate of the cost of meeting a liability as a proper deduction from income of a taxpayer on the accrual basis, even when the work is not done and the precise cost is, therefore, not ascertainable until after the expiration of the fiscal year. The matter is discussed and clarified by Justice Brandeis in *Lucas* v. *American Code Co.*, 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538, where he held that a corporation, which had broken a contract with a sales manager employed on a commission basis, could not accrue its liability on its books pending the termination of a suit for damages for breach of the contract. He said, 280 U.S. at pages 449-450, 50 S. Ct. at page 203:

Generally speaking, the income tax law is concerned only with realized losses, as with realized gains. *Weiss* v. *Wiener*, 279 U.S. 333, 335, 49 S. Ct. 337, 73 L. Ed. 720. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. As respects losses occasioned by the taxpayer's breach of contract, no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test. . . .

. . . The Board of Tax Appeals has held, in a series of well-reasoned opinions, that a loss occasioned by the taxpayer's breach of contract is not deductible in the year of the breach, except under the special circumstances where, within the tax year, there is a definite admission of liability, negotiations for settlement are begun, and a reasonable estimate of the amount of the loss is accrued on the books.

In a note appended to this text, 280 U.S. at page 450, 50 S. Ct. at page 203, a number of decisions of the Board of Tax Appeals are cited which relate to the right of a taxpayer to take a deduction for a loss due to breach of contract on its part. Deduction in the taxable year was disallowed in most of them because the taxpayer denied liability at that time and settlement was not made until a subsequent year. But where liability was admitted, and the amount thereof was reasonably predictable in the tax year, deduction in that year of the precise sum subsequently arrived at was allowed. . . .

Again the subject was discussed by Justice Brandeis in *Brown* v. *Helvering*, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725, where it was held that a general agent of an insurance company, who was paid an overriding commission on the business written each year subject to partial repayment in case of subsequent cancellation of the policy, could not accrue and deduct an estimated amount to cover these cancellations since the agent's right to receive the commission in the first place was absolute while the deduction was based on an uncertain contingency. In the course of the opinion he said, 291 U.S. at page 200, 54 S. Ct. at page 359:

It is true that, where a liability has "accrued during the taxable year," it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due, *United States* v. *Anderson*, 269 U.S. 422, 440, 441, 46 S. Ct. 131, 70 L. Ed. 347; *American National Ins. Co.* v. *United States*, 274 U.S. 99, 47 S. Ct. 520, 71 L. Ed. 946; *Aluminum Castings Co.* v. *Routzahn*, 282 U.S. 92, 51 S. Ct. 11, 75 L. Ed. 234, and although the amount of the liability has not been definitely ascertained. *United States* v. *Anderson, supra.*

In *Ocean Accident & Guarantee Corp.* v. *Com'r*, 47 F.2d 582, it was held that the estimate of an insurance company of liability likely to arise in subsequent years by reason of accident or injury covered by its insurance policies was sufficiently accurate to warrant a deduction from income in the current year, athough obviously the facts were neither known nor knowable in that year. The estimate, however, was accepted as a valid basis for the accrual because it took into account all of the policies issued by the taxpayer, and was therefore an aggregate of the estimates of policy losses likely to occur which past experience had shown was accurately predictable.

We conclude that when all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of the liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction

thereof from income may be taken by a taxpayer on an accrual basis. This procedure does not violate the principle that income taxes must be calculated on an annual basis, but, on the contrary, allocates to each year the proper income and expense, and prevents distortion of the taxpayer's financial condition in the tax year. See *United States* v. *Anderson,* 269 U.S. 422, 440, 46 S. Ct. 131, 70 L. Ed. 347. It gives heed to the true facts of each case rather than to an arbitrary rule of thumb; and the adjustments which must be made after the precise amount is ascertained are as easily consummated as those which are required when it is impracticable to make precise calculations of income or outgo before the end of the year, although all of the events which fix the amount have accrued therein. We think the proper approach to the problem before us should be realistic and one that accords with good business practice, rather than an approach based upon subtle technicalities.

The decision of the Tax Court is reversed and the case remanded for further proceedings in accordance with this opinion.

Reversed and remanded.

Note

1. Deductions were denied to other strip miners for similar obligations to "backfill" leased property in *Patsch* v. *Commissioner,* 208 F.2d 532 (3d Cir. 1954), and *Vincent* v. *Commissioner,* id. 501, 519, the *Harrold* case being distinguished on none too persuasive factual grounds. In the *Capital Warehouse Co.* case, cited by the court, the deduction of an amount estimated as the cost of "handling out" stored goods was denied:

> Certainly the amount of the taxpayer's liability to its customers for the expense of loading out their merchandise in future years was not "fixed" in the taxable year nor did the particular event upon which the amount depended occur in the taxable year. That event was the determination of the actual cost of loading out at the time the merchandise was ordered out by the customer. Here the petitioner has only estimated such cost . . . It is true petitioner's liability, that is its obligation to pay the cost of "handling out," had become final during the taxable years in the sense that it was not a contingent liability; but the amount of the liability or cost of handling out was not definite or fixed. (171 F.2d 395, 398 (1948).)

In general, taxpayers have not been allowed to deduct additions to reserves for expenses to be incurred under contracts to maintain, service, or replace products, for discounts or allowances to be granted to customers who pay on time or who return containers,or for refunds that may have to be made upon the cancellation of contracts or the return of goods. See Note, Accounting Principle v. Tax Practice: Treatment of Deferred Credits and Reserves, 61 *Harv. L. Rev.* 1010 (1948).

In *Central Cuba Sugar Co.* v. *Commissioner*, 198 F.2d 214 (2d. Cir. 1952), a manufacturer of sugar was permitted to accrue, for the year in which it entered into contracts to sell its products, commissions to be paid to brokers for negotiating the sales, although the sugar was not to be delivered or paid for until a later year. The commissions were subject to certain adjustments at the time of shipment, and would be forfeited if the purchasers defaulted. The court, in allowing the commissions to be accrued when the contracts were made (at which time the sales price was also accrued), said the deduction fell "squarely within the principle" laid down in the *Harrold* case:

> Here the services had been performed, and the possibility that some of the contracts might not finally be executed was, if anything, a condition subsequent to payment by taxpayer. And the adjustments of the commissions in accordance with the final

> weight of the sugar shipped were insubstantial. Where the amount of the obligation and its final payment is so certain as here, it would seem the height of business judgment and tax wisdom to establish a reserve and deduct the expense thus set aside in the year in which the related income accrues. (198 F.2d at 217-218)

A similar position was taken as to commissions that would likewise be forfeited if the customer defaulted in *Ohmer Register Co.* v. *Commissioner,* 131 F.2d 682, 686 (6th Cir. 1942), where the court said:

> The fact that the agent might not, in the end receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold.

With the *Central Cuba Sugar Co.* and *Ohmer Register Co.* cases, compare *Tennessee Consolidated Coal Co.* v. *Commissioner*, 15 T.C. 424 (1950), involving vacation pay to be paid by the taxpayer in the following year under union contracts. Under the contracts, employees with a record of 12 months continuous service with the taxpayer were entitled to vacation pay of stipulated amounts. The taxpayer accrued one-twelfth of this amount each month for each employee; there were 450–500 employees, of whom not more than 8 or 10 ordinarily left the taxpayer's employ in any one year. The deduction was denied on the ground that no individual miner had

> any right to any part of his vacation pay until he has completely complied with every part of the contract . . . Liability for payment in the instant case depended on a condition precedent, *i.e.*, whether or not the miners, individually, were working for the company on the date required in the contract and had complied with the requirements contained therein. . . . There might be strikes or changes in amount of vacation payments. The petitioner has not shown that there was not possibility or probability thereof. (15 T.C. 424, 430–431.)

Only a year before this case was decided, the Bureau ruled that a taxpayer on the accrual basis could accrue a liability for vacation pay under similar circumstances. The contract provided that any employee who worked 160 days during the year would get vacation pay in the following year, unless he left the employer's employ (except for illness, disability, furlough, or temporary lay-off) before the scheduled vacation period. The ruling argued.

> After the end of a taxable year, the liability for vacations with pay (or pay in lieu thereof) may, with respect to some employees, be terminated if the employment relation is terminated prior to the scheduled vacation period. This circumstance, however, will not preclude the accrual of vacation pay at the end of the taxable year in which the services are performed, since, with respect to the individual employee at the end of such year, the employer would be justified in anticipating that the liability will be paid. . . . or, with respect to the employees as a group, such circumstance would only make uncertain the ultimate amount of liability to the group. (I.T. 3956, 49–1 C.B. 78, 79–80.)

But see *Sheldon* v. *Commissioner*, — F.2d — (6th Cir. 1954).

2. The law in this area is drastically modified by § 462 of the 1954 Code. Note the breadth of the Treasury's discretion in allowing reserves for estimated expenses. The Senate Report says (pp. 306–307) of the type of expenses for which reserves may be created under § 462:

> The Secretary or his delegate must be satisfied that the expenses can be estimated with reasonable accuracy. For example, if cash discounts are allowed customers for prompt payment, and the taxpayer can predict from experience the approximate percentage of the allowable discounts which will be taken (even though he cannot name the customers with certainty) he will be permitted a deduction in the year in which the sales are reported equal to the discounts which will be realized in the process of collecting the accounts. If repairs or replacements will have to be made under guaranty on products sold during the year, and the average

cost of such repairs or replacements can be estimated with reasonable accuracy, the taxpayer may take as a deduction in the year of such sales a reasonable addition to a reserve for product guaranties. The balance in the reserve at the close of each taxable year must be adjusted to reflect the estimated liability of the taxpayer with respect to outstanding guaranties. Other illustrative items for which such reserves might be set up in appropriate cases include sales returns and allowances, freight allowances, quantity discounts, vacation pay, and certain liabilities for self-insured injury and damage claims. The Secretary or his delegate may disallow additions to any reserve of this type if he finds that the costs and expenses for which provision is made are not reasonably supported by the taxpayer....

The reserve method is not to be allowed for costs and expenses of a contingent or contested nature and as to which there is no reasonable certainty of their amount. Reserves created for general undetermined contingencies, indefinite possible future losses, expenses and losses not reasonably related to the taxable year, or for specific expenses and losses that are being contested or are in litigation, cannot ordinarily be estimated with reasonable accuracy and are not to be the basis for additions to reserves under this section.

3. See generally Comment, Accrual: The Uncertain Concept of Certainty—A History of the All Events Test, 21 *U. of Chi. L. Rev.* 293 (1954).

4. *The Use of Inventories*

Note: **Sections 471 and 472 of the 1954 Code, relating to the use of inventories, are derived, without substantive change, from §§ 22(c) and 22(d) of the 1939 Code.**

See Regs. 118, Secs. 39.22(c)-1-5.

HERBERGER v. COMMISSIONER

U. S. Court of Appeals, Ninth Circuit, 1952

195 F.2d 293

Before MATHEWS, STEPHENS and BONE, Circuit Judges.

MATHEWS, Circuit Judge.

Petitioners, George and Mabel Herberger, seek review and reversal of two decisions of the Tax Court determining income tax liability for 1942, 1943 and 1944, one determining George's liability and one determining Mabel's liability.

During the taxable years, petitioners were husband and wife, resided in California and were engaged in the business of processing and selling pickles. Most of their income was derived from that business. All their income was community income—income in which their interests were equal.

Petitioners bought for cash, not on credit, the cucumbers and other materials and supplies used in their business. They usually sold for cash, not on credit, the pickles they processed. Occasionally, however, pickles sold in one year were paid for in the following year. Thus petitioners received $171.40 in 1943 for pickles sold in 1942 and received $946.86 in 1944 for pickles sold in 1943. The method of accounting reguarly employed in keeping petitioners' books was the cash receipts and disbursements method. Petitioners' income tax returns were made on a cash basis.

Petitioners sold 1626 barrels of pickles to Henry Harmel and received therefor $29,268 in three payments, one of $10,000, one of $4,878 and one of $14,390. Petitioners say that the pickles for which they received the $10,000 were sold in 1944; that the pickles for which they received the $4,878 and the $14,390 were sold in 1945; that they received the $10,000 in 1944 and received the $4,878 and the $14,390 in 1945; and their right to the $10,000 accrued in 1944; and that their right

to the $4,878 and the $14,390 accrued in 1945. The Tax Court found, in substance and effect, that all of the 1626 barrels of pickles were sold in 1944; that petitioners received the $10,000 and the $4,878 in 1944 and received the $14,390 in 1945; and that their right to the $10,000, the $4,878 and the $14,390 accrued in 1944. These findings were supported by substantial evidence and were not clearly erroneous. We therefore accept them as correct. . . .

The Commissioner of Internal Revenue determined, and the Tax Court agreed, that the cash receipts and disbursements method of accounting—the method regularly employed in keeping petitioners' books—did not clearly reflect their income, and that the accrual method of accounting did clearly reflect their income. Therefore the Tax Court computed their income in accordance with the accrual method of accounting. Thus the Tax Court included in their gross income for 1942 the $171.40 received in 1943 for pickles sold in 1942, included in their gross income for 1943 the $946.86 received in 1944 for pickles sold in 1943 and included in their gross income for 1944 the $14,390 received in 1945 for pickles sold in 1944.

Petitioners contend that the cash receipts and disbursements method of accounting clearly reflected their income, and that therefore the Tax Court should have computed their income in accordance with that method of accounting, should not have included in their gross income for 1942 the $171.40 received in 1943 for pickles sold in 1942, should not have included in their gross income for 1943 the $946.86 received in 1944 for pickles sold in 1943 and should not have included in their gross income for 1944 the $14,390 received in 1945 for pickles sold in 1944. We reject these contentions for the following reasons:

In petitioners' business, the purchase and sale of merchandise—the purchase of cucumbers and other materials and supplies and the sale of pickles—were income-producing factors. Therefore, in order to reflect their net income correctly, it was necessary to take inventories of merchandise on hand at the beginning and end of each taxable year and to use them in computing their net income. See §§ 39.22 (c)-1 and 39.41-3(1) of Treasury Regulations 118.[1] Petitioners did so take and use such inventories. Therefore no method of accounting in regard to purchases and sales correctly reflected their income except an accrual method. See § 39.41-2 of Treasury Regulations 118.[2] To hold, as petitioners would have us hold, that the cash receipts and disbursements method of accounting clearly reflected their income would be to disregard §§ 39.22(c)-1, 39.41-2 and 39.41-3(1). This we decline to do.

1 Section 39.22(c)-1 provides "In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor." Section 39.41-3(1) provides: "In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year. . . ."

2 Section 39.41-2 provides: "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . . For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. . . ."

In support of their contention that the cash receipts and disbursements method of accounting clearly reflected their income, petitioners cite *Beckman* v. *Commissioner of Internal Revenue*, 8 B.T.A. 830; *Mann* v. *Commissioner of Internal Revenue*, 59 App.D.C. 103, 35 F.2d 873; and *Glenn* v. *Kentucky Color & Chemical Co.*, 6 Cir., 186 F.2d 975. The *Beckman*, *Mann* and *Glenn* cases differ materially from the cases at bar and are, we think, not in point here. However, if and to the extent that the *Beckman*, *Mann* and *Glenn* cases support petitioners' contention, we regard them as erroneous and decline to follow them.

We conclude that the Tax Court correctly computed petitioners' income for the taxable years.

Decisions affirmed.

Note

See § 446(c)(4) of the 1954 Code.

BLATTMACHR, KNAPP, AND WARREN
ACCOUNTING PERIODS AND ACCOUNTING METHODS

New York: Practising Law Institute (rev. ed., 1952) pp. 86–97
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Inventory Valuation

An inventory is an itemized list, with valuations, of goods held for sale in a business and includes, in the case of a manufacturer, finished goods, goods in process, raw materials and supplies *if* acquired for sale *or* will physically become part of the merchandise intended for sale.* In order to reflect the taxpayer's income correctly, inventories of merchandise on hand must be taken at the beginning and end of every taxable year in all cases in which the production, purchase or sale of merchandise is an income producing factor.

In certain businesses inventories are not permitted either because the transactions are so infrequent that an inventory is unnecessary to reflect income properly or because to take an inventory is both impracticable and contrary to good accounting practice.[1] While inventories usually relate to physical items, intangibles such as stocks and bonds may be inventoried in the case of a security dealer.

* Regs. 118, Sec. 39.22(c)–1, provides: "The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. . . ." The requirement that raw materials either be intended for sale or physically incorporated in the finished goods was added to the regulations in 1933; previously the regulations permitted an inventory of "raw materials and supplies on hand that have been acquired for sale, consumption, or use in the productive processes." Under this regulation, it was held that "oil needed to keep machinery going, bolts without which it will not go, fabricated parts which must be restored, pumps to keep out water, wiring for dynamos and generators" came within the phrase "raw materials and supplies . . . acquired . . . for consumption, or use in the productive processes," and that inclusion of such supplies in inventory would be permissible if in accord with accounting custom *Francisco Sugar Co.* v. *Commissioner*, 47 F.2d 555 (2d Cir. 1931). Under the amended regulations now in force, such supplies would not be inventoried under § 471. But note the indirect recognition in Regs. 118, Sec. 39 23(a)–3, that incidental materials and supplies might have to be inventoried in order to reflect net income clearly. Perhaps the distinction is that materials that will be physically incorporated in finished goods not only must be inventoried but if the taxpayer chooses may be valued at cost or market, whichever is lower, while other materials, if inventoried, would have to be carried at cost. [Ed]

[1] *E.g.*, real estate, fish nurseries

The Regulations[2] provide that the inventory be taken in conformance with the best accounting practice in the trade or business and clearly reflect income. Inherent in these basic requirements is the rule of consistency. Consistency is required in three respects (1) in the method or basis used from year to year, (2) in the method or basis applied to all items in one year, and (3) to the opening and closing inventories of each taxable year. . . .

As pointed out in *City Ice Delivery Co.* v. *United States*, 176 F.2d 347 (4th Cir. 1949), the Regulations also require that the inventories be recorded, properly computed, summarized and preserved as part of the taxpayer's accounting records. In addition, it is important to know if the taxpayer has title to the goods on hand. For title to goods is one of the determining factors in deciding whether to include in the seller's or buyer's inventory goods sold on C.O.D., on approval, on consignment, or fungible goods, such as wheat or oil, which have not as yet been segregated and appropriated to the contract, or goods in transit. The person having title to the goods generally includes them in his inventory. The passage of title is determined by reference to the applicable state law which in most instances uses the criterion of intent as the controlling factor Thus the buyer or seller may mold the sale and purchase contract to suit his own conveniences and objectives. . . .

1. Methods of Valuing Inventory

It is important to differentiate between the problems relating to accounting for "quantities" or "units" of goods on hand and the "dollar valuation" thereof. The method generally used to account for "quantity" is called first-in or first-out or "FIFO" and is based on the assumption that the goods first acquired are sold first.

The recognized methods of valuing inventory are on the basis of (a) cost, (b) cost or market, whichever is lower, or (c) market. The cost method is also used in conjunction with (d) the retail method and (e) the elective method more commonly known as "LIFO" which, contrary to "FIFO" assumes that the goods purchased last are sold first. Except where LIFO is used [3] or where a farmer uses the unit livestock price method [4] not only must the same method of inventory valuation be used each year but the same method must be applied to the entire inventory.

a. Cost. This method requires the valuing of the units on hand on the basis of their actual cost, generally considering the latest units purchased to be those on hand.[5] This formula for identifying the units for cost valuation is as previously stated the first-in, first-out or FIFO method. To the merchandise cost must be added the freight and handling charges and other similar expenses necessary to acquire possession of the goods. Trade discounts are deductible from the net invoice price but cash discounts are deductible at the taxpayer's election. In the case of a manufacturer, his inventory would include the cost of raw materials and supplies consumed, the direct labor expenditures, and the overhead attributable to production excluding, however, selling and similar expenses. Average costs for several items may be used where a more accurate computation is not feasible and if consistent and accurate results are obtained.

b. Market. This method requires the valuing of the units on the basis of their

[2] Regs. 118, § 39.22(c)-2.
[3] I.T. 3456, 1941-1, C.B 201 allows "lifo" to be limited to a specific portion of the inventory.
[4] Regs. 118, § 39.22(c)-6.
[5] *Ibid.*, § 39.22(c)-3.

market price at the date of the inventory, or the nearest date on which a quotation is available.[6] Market price is the price prevailing in the place where the taxpayer's usual source of supply is located. Where the goods are no longer obtainable, the taxpayer's selling price less his selling costs may be used. For manufacturers, the market price is the reproduction cost on the date of the inventory.

c. Cost or market. This method first requires the user to determine the cost of the units on hand (as in the cost method) and then to compare such valuation with the market value of identical items on the inventory date (as in the market method). The lower of the two must then be used.[7] It should be noted here, however, that whenever an item was included in a previous inventory, its value in such previous inventory is deemed to be its cost. . . .

d. Retail method. Retail merchants are permitted to employ the "retail method" of evaluating inventories which is the method used particularly by department stores. This method is set forth in the Regulations[8] and can best be described by illustration. Assume that in one department of a large store, the total of the opening inventory and purchases at cost during the year equals $200,000 and that the retail selling price was $300,000. The net mark-up is $100,000 or 33⅓ percent of the selling price. If the selling price of the closing inventory were $60,000, the amount equal to 33⅓ percent of the closing inventory is deducted therefrom and the result is the closing inventory value. In this hypothetical case, $20,000 would be subtracted from $60,000, leaving an inventory value of $40,000.

It should be noted that where a taxpayer maintains more than one department in his store or deals in classes of goods carrying different percentages of gross profit, such taxpayer may not use a percentage of profit based upon an average of his entire business; the taxpayer must use the "retail method" separately for each department or class of goods.

e. Last-in first-out. This method, sometimes called LIFO, treats the initial inventory as acquired at its average cost and treats the closing inventory as consisting first of the opening inventory with any excess allocated to purchases which are included at taxpayer's option at the earliest, latest or average price paid during the taxable period.[9] Practically speaking, it is a special variant formula for identifying units where the cost method of valuation is employed. The many rules and requirements for the use of this method are complicated and technical. . . .

f. Other inventory problems. Where an inventory contains goods that cannot be sold at normal prices, such as damaged goods, odd and broken lots or second hand goods, the proper price to include such items in the inventory is at their bona fide selling price less the direct cost of selling, regardless of whether the inventory is taken at cost or market whichever is lower. . . .

Since opening inventory is a debit and, therefore, serves to reduce income, while closing inventory is a credit and serves to increase income, the relative advantages of one method over any one of the others should be carefully considered. Where a taxpayer is engaged in a business in which prices are fairly stable, inventory may be valued at cost (cost method) since only one pricing is necessary and of all the methods this is probably the simplest to use.

On the other hand, where the market fluctuates considerably, the method of cost

[6] *Ibid.*
[7] *Ibid.*, § 39.22(c)-4.
[8] *Ibid.*, § 39.22(c)-8.
[9] I.R.C. § 472.

or market whichever is lower, may be desirable. If the market has fallen below cost, advantage can be taken, if this method is used, of the lower market prices which will serve to reduce tax liability for the year in question. It must be borne in mind that doing so will tend to increase the income of the following year, since the closing inventory of one year must invariably be used as the opening inventory of the next year. The market method may be used and is ordinarily employed by dealers in securities and by dealers in grain, cotton and other fungible commodities dealt in on commodity exchanges. The reason for this becomes apparent when one considers the wide fluctuation in the value of securities and commodities traded on exchanges.

The last-in first-out, or LIFO, method was permitted in order to prevent the distortion of income because of rapidly falling or rising markets. Since, in this case, the goods deemed to be sold are those last purchased, and since, selling prices follow purchases, it will be seen that as costs rise and sales prices consequently rise, the spread between costs and selling prices will remain fairly constant and vice versa. This is not so in the case of the first two methods mentioned, because there, items sold are deemed to be from earliest purchases. If the market rises very rapidly the spread may be so great as to increase income and, therefore, taxes, leaving the taxpayer with the highest valued purchases in his inventory. In turn, this will serve in the following periods to unduly depress income. The LIFO method avoids these extremes and prevents distortion of income or losses.

The effect of a rising or falling market on the profit or loss of a business using inventories may be seen from the following examples:

1. Cost Method:

a. Rising Market

Gross Sales	10 items		$30.00
Less. Cost of Sales			
Opening Inventory	5 items @ $2	$10.00	
Purchases	10 items @ $2.50	25.00	
Goods Available for Sale		$35.00	
Less: Closing Inventory	5 items @ $2.50	12.50	
Cost of Sales			22.50
Gross Profit			$7.50

Since it is assumed in most cases that the goods first in are sold first (FIFO) and that the most recent purchases comprise the inventory, the closing inventory will always be valued higher in a rising market than actually may be the case. In the example above, the 5 units on hand in the closing inventory may actually have cost $2 or more each, as the case may be.

b. Falling Market:

Gross Sales	10 items		$25.00
Less: Cost of Sales			
Opening Inventory	5 items @ $2	$10.00	
Purchases: April	5 items @ $2	10.00	
Oct.	5 items @ $1.50	7.50	

Goods Available for Sale		$27.50	
Less: Closing Inventory	5 items @ $1.50	7.50	
Cost of Sales			20.00
Gross Profit			$5.00

Likewise the 5 items comprising the closing inventory may actually have cost $2 each or less, as the case may be, and their market value may have been $1 each or a total of $5.

2. *Cost or Market, Whichever is Lower:*

This method requires unrealized losses to be taken and will result in the return of a smaller profit while prices are falling since losses will be taken as soon as the downturn starts. This may be illustrated as follows:

Gross Sales	20 items		$40.00
Less. Cost of Sales			
Opening Inventory	10 items @ $1.50	$15.00	
Purchases:	17 items @ 1.50	25.50	
	3 items @ 1.00	3.00	
Available for Sale		$43.50	
Less. Closing Inventory			
10 items at market of 75¢		7.50	
Cost of Sales			36.00
Gross Profit			$ 4.00

Under the cost method, the closing inventory would have been valued at $13.50 (3 items cost $1 and 7 items cost $1.50) so that the gross profit would have been $10 rather than the $4 as shown above. Note that both the cost and the lower of cost or market methods use the first-in-first-out, or FIFO, method of accounting.

3. *Last-in-First-Out (LIFO):*

a. *Rising Market:*

		"LIFO"		"FIFO"
Sales	20 units	$90 00		$90.00
Less. Cost of Sales				
Opening Inventory	10 units @ $2	$20.00		$20.00
Purchases: Feb.	5 units @ $2	10 00		10 00
July	8 units @ $2.50	20.00		20.00
Dec.	10 units @ $3	30.00		30 00
Available for Sale		$80.00		$80.00
Less: Closing Inventory				
	10 units @ $2		10 units @ $3	
	3 units @ $2	26.00	3 units @ $2.50	37.50
Cost of Sales		54.00		42.50
Gross Profit		$36.00		$47.50

In calculating the closing "lifo" inventory, the earliest purchase prices were used to cost the inventory increase during the year. . . .

b. Falling Market.		"LIFO"		"FIFO"
Sales	20 units	$60.00		$60.00
Less Cost of Sales				
Opening Inventory	10 units @ $2.00	$20.00		$20.00
Purchases Feb.	5 units @ $2.00	10.00		10.00
July	8 units @ $1.50	12.00		12.00
Dec.	10 units @ $1.20	12.00		12.00
Available for Sale		$54.00		$54.00
Less: Closing Inventory				
	10 units @ $2		10 units @ $1.20	
	3 units @ $2	26.00	3 units @ $1.50	16.50
Cost of Sales		28.00		37.50
Gross Profit		$32.00		$22.50

Thus in a period of rising prices, LIFO tends to show smaller profits than FIFO; contrariwise, in a period of falling prices, LIFO would tend to show larger profits than FIFO so that over a cycle, the spread between profit and loss would be least in the LIFO method of inventory accounting.

The method of inventory valuation may not be changed by the taxpayer except with the consent of the Commissioner of Internal Revenue and is subject to the conditions prescribed by him.[10]

Note

See also Ahern, "Getting the Best Effective Use Out of Accounting Methods and Accounting Periods," *6th Annual N.Y.U. Inst. on Fed. Taxation* 479, 509–518 (1948); Barker, "Practical Aspects of Inventory Problems Under Current Conditions: Lifo, Involuntary Liquidations," *10th id.* 511 (1952); Sweeney, "Mercantile Inventory Treatment for Income Tax Purposes," 14 *U. of Pitt. L. Rev.* 538 (1953).

BUTTERS
EFFECTS OF TAXATION: INVENTORY ACCOUNTING AND POLICIES

Boston: Harvard University Press (1949) pp. 138–141

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Taxable Income

The standards which must be applied in deciding how to value inventories in determining taxable income are different from those applicable to a business profits concept. For the latter purpose, . . . the essential criterion is the usefulness of a given profits concept to management and to the public. In particular, the dangers of ill-considered management decisions or public policies based on mis-

[10] Regs. 118, § 39.41–2. [See § 446(e), 1954 Code.]

interpreted corporate reports should be minimized. To this end, a strong case can be made for excluding from annual profits various nonrecurring gains and losses on the ground that their inclusion would distort current operating profits and hence not furnish the best guide for policy decisions. The exclusion of inventory profits from business income can be defended on this basis.

For tax purposes, on the other hand, these considerations are relevant only to the extent that tax requirements modify business accounting practices. Since tax returns are confidential, the problem of public misinterpretation simply does not arise, except as national income and aggregate corporate profits estimates are based on unadjusted tax data. Also business profits as computed for management and stockholder purposes may and do vary from taxable income, especially on such matters as the treatment of nonrecurring gains and losses not associated with usual operations.

From the tax viewpoint, different criteria, such as a consistent treatment of different taxpayers and different sources of income, are much more important.[1] To satisfy these criteria the tax treatment of inventory profits should be consistent with the general concept of taxable income.

Two characteristics of this concept are of special relevance to the taxation of inventory profits. First, the American concept of taxable income is very inclusive; by and large, all gains—recurring or nonrecurring—are taxable. In particular, capital gains, though subject to differential rates, constitute an integral component of taxable income. Secondly, income is subject to taxation only when realized.

The question with respect to inventory profits then is whether these profits can properly be regarded as unrealized in an economic sense. (There is, of course, no doubt that they constitute realized income in a legal sense.) As already indicated, the proponents of LIFO have long contended that to the extent that inventories constitute an investment essential to the effective operation of a business—they can be so regarded. Under these conditions, while individual units of inventory are constantly turning over, the contention as developed above is that inventory as a whole is more analogous to a fixed asset. If this proposition is granted, increases in the market value of a constant quantity of inventory goods can reasonably be regarded as unrealized (indeed unrealizable) capital gains not appropriately subject to taxation.

To the extent, however, that inventories are held in excess of continuing needs and can be liquidated without danger to the long-run operations and earning power of the company, the analogy between inventories and fixed assets breaks down and with it the justification for exempting inventory profits from taxable income. This analogy also breaks down in one other respect. The LIFO method permanently excludes inventory profits and losses from income as long as the inventories continue to be held. In this respect, unrealized inventory profits—assuming prices have risen—are given more favorable treatment than unrealized capital

[1] Other relevant criteria for the determination of taxable income, such as economic effects and administrative feasibility, are discussed elsewhere (see Chapters V and VIII–XI) and hence are not treated here. In general, they do not point to a different conclusion. Various other problems remain, such as the practicality of distinguishing between the fixed and variable components of inventories, the appropriate tax treatment for inventory increments and decrements during the year, and the problems raised by seasonal fluctuation of inventories These problems, though briefly considered in this chapter, are treated more extensively in Chapter XI.

gains on depreciable assets. Gains on depreciable assets which have appreciated in value are gradually and indirectly taken into income because depreciation charges on a cost basis understate the current market value of the capital consumed in production. In this respect the treatment of LIFO inventories is more analogous to that of land than to depreciable assets.[2]

National Income

For national income purposes, to turn to the third use of profits data, the objective is to measure the physical quantity of goods and services produced (net or gross) in terms of a stated price level—usually average prices for the current year or for some base year. To achieve this measurement, sales and costs must be stated in terms of the same price level. It clearly would be wrong to measure sales in, say, 1948 prices and the costs of these sales partly in 1947 and partly in 1948 prices. But this is precisely what traditional corporate accounting does when inventories are valued on a FIFO or average-cost basis. The inventory valuation adjustment as computed by the Department of Commerce is designed to avoid such incongruities by placing cost prices on a current basis. It manifestly represents a necessary adjustment to profits as computed for national income purposes. This is not to say, of course, that for other than national income purposes profits sometimes may be appropriately computed without the inventory valuation adjustment.

LIFO INVENTORY ACCOUNTING

Statement of *Wallace M. Jensen,* American Institute of Accountants, before House Committee on Ways and Means, July 21, 1953

Hearings on General Revenue Revision, House Committee on Ways and Means, 83d Cong., 1st sess., pp. 607–610

Mr. Jensen. My subject is, Topic 19, LIFO Inventory Accounting.

My name is Wallace M. Jensen, of Detroit, Mich. I am a certified public accountant, and I appear before you in my capacity as chairman of the subcommittee on current tax legislation, committee on Federal taxation, American Institute of Accountants.

It is my privilege to present to you the recommendation of the committee on Federal taxation of the American Institute of Accountants that the Internal Revenue Code be amended to permit taxpayers using the LIFO inventory method for income-tax purposes an election to value such inventories at the lower of cost or market.

Section 22 (d) [§ 472 of the 1954 Code] as presently worded and in its

[2] This exclusion of a portion of inventory profits from taxable income until the inventories are liquidated has been cited by critics as a reason for not allowing LIFO to be used for tax purposes. The point obviously has force, but the decisive question is: How much importance should be assigned to it in appraising the whole issue? In this connection, it is important to note that, while the amounts excluded from income may be large in absolute size, or in relation to the income of a single year, they will ordinarily constitute a very small percentage of the aggregrate income earned by any company over a substantial period of years. It is, of course, quite possible that losses rather than gains will be excluded in the long run, since future prices may fall below LIFO base prices for many companies; they have already done so in a few instances.

early application by the Bureau of Internal Revenue has led to certain inequities certainly not envisaged by the LIFO proponents who strongly urged its passage during the late 1930's nor intended by Congress in its enactment in the Revenue Act of 1939.

In the determination of periodic income, one of the most important determinations to be made is the pricing of inventories in order that appropriate costs may be matched against revenue. Although the primary basis of accounting for inventories is cost, generally accepted accounting principles require a departure from the cost basis when the usefulness of the goods in inventory is no longer as great as its cost. The measurement of such loss in utility is accomplished by applying the rule of pricing inventories at cost or market, whichever is lower. Cost for inventory purposes may be determined under any of the several assumptions as to the flow of cost factors, such as "first-in, first-out," "average," and "last-in, first-out," the method used being the one which under the circumstances most clearly reflects periodic income. The method used must, of course, be consistently applied.

These are the generally accepted accounting principles underlying the issue, which principles are set forth in Accounting Bulletin 29, issued by the committee on accounting procedure of the American Institute of Accountants (July 1947).

Initially, by the Revenue Act of 1938, the use of LIFO was authorized only for specified raw materials used by tanners and the producers and processors of certain nonferrous metals. The following year Congress, in the Revenue Act of 1939, substituted the present wording of section 22 (d) (1) with the intent that such change would expand the use of LIFO by extending the LIFO option "to all taxpayers who use it, apply for it, and use it consistently, regardless of the business in which the taxpayer is engaged." [S. Rept. No. 648, 76th Cong., 1st sess., reprinted in 1939-2 C.B. 528.]

After the enactment of the Revenue Act of 1939, although the expressed intention of Congress was that the LIFO election was available to all taxpayers, subject, of course, to the proviso that the use of LIFO most clearly reflected periodic income, opposition to the general use of LIFO was encountered in the attitude of the Commissioner of Internal Revenue. Although the application of LIFO to commodities that could be accounted for in terms of quantities was accepted readily by the Commissioner, its application to inventories composed of heterogeneous goods, which in general was based on a computation of relative dollar value with the year of adoption of LIFO being considered the standard for the value of the dollar, was challenged. Because of the Commissioner's attitude, many taxpayers refrained from the adoption of the LIFO method and most of the taxpayers who had initially adopted LIFO gave up their right to the use of LIFO and reverted to their former method of inventory valuation. However, other taxpayers took up the challenge and subsequently received favorable decisions from the Tax Court.

These cases, *Hutzler Brothers Company* (8 T.C. 14 (1947)), and *Edgar A. Basse* v. *C.I.R.* (10 T.C. 328 (1948)), gave recognition to the use of acceptable methods other than item identification as the basis for a LIFO evaluation and, as a result, the Commissioner abandoned his previous position. The regulations prescribing the permissible methods of LIFO application were accordingly amended on March 4, 1948 (T.D. 5605), and November 2, 1949 (T.D. 5756), and thus, for

the first time in more than 10 years since the general LIFO provision was included in the law, the broad principles of applying LIFO to inflated business inventories were made available to all classes of business.

But by the time the right of all taxpayers, regardless of business, to the use of the LIFO method of inventory valuation was established, another obstacle to the prudent adoption of the method manifested itself. That was the uncertain trend of the price level during the years of 1948 and 1949 and even until the outbreak of the Korean war in mid-1950. Those businesses which were prevented from adopting practical applications of LIFO in the early 1940's due to the narrow interpretations of the Bureau now found they were faced with the choice of adopting LIFO with a consequent freezing into their inventory valuation of a high cost level which would grossly overstate their reported profits as prices declined or continuing on their present method of reflecting inventories at the lower of cost or market. It was, therefore, not until the latter part of 1950 when prices again began to rise that the use of LIFO as a means of eliminating inflation from inventory values again became recognized as a prudent policy. . . .

Under conditions as they exist today, then, there are three classes of taxpayers as regards the use of LIFO. First, those taxpayers whose LIFO methods found ready acceptance by the Commissioner and those whose LIFO methods found acceptance after litigation, both of which classes have found competitive advantage by the use of LIFO to eliminate all or the greatest portion of the increase in the price level from their inventory values. Second, those taxpayers discouraged by the Bureau's position through the years of greatest increase in the price level who subsequently adopted LIFO during 1950 and 1951 but who have not enjoyed advantages comparable to those derived by the taxpayers of the first class. Third, those taxpayers who presently desire to adopt LIFO but feel the risks too great because of possible declines in the price level at the termination or leveling off of the defense program.

The proposed amendment to permit the use of the lower of LIFO cost or market will tend to equalize the position of all taxpayers who have elected or may elect to use the LIFO method of inventory valuation. The LIFO inventory method is not readily adaptable to all business but, if given the right to value a LIFO inventory at the lower cost or market, undoubtedly more taxpayers would elect to use LIFO. If prices then receded, those taxpayers would be obtaining no greater benefit than if they were to wait for prices to decline to a lower level and then elected to use LIFO beginning at a more fortuitous general price level. The practical justification for the proposal to permit writedown of LIFO inventories to market, therefore, is to remove the inequities between taxpayers. Collateral to such inequities is the fact that taxpayers who now desire to adopt LIFO for the purpose of eliminating inflation from reported profits but hesitate because of the fear of severe price declines with a consequent freezing of high costs in inventory and distorted incomes as a result thereof, are directly contributing to inflation by necessarily following inventory practices which inflate reported profits upon which income and excess-profits taxes, dividends, and wage increases are paid.

But beyond this practical justification is the reason founded in the generally accepted accounting principles incident to inventory pricing that no inventory carried at an amount in excess of market is realistic and that any loss in utility

of the goods, measured by market, is to be recognized and accounted for in the period in which such loss of usefulness occurs. It is patently unfair and contrary to sound principles of taxation that a tax be imposed upon profits which are overstated because of the failure to recognize a measurable decline in the value of an inventory.

ELDRIDGE

ISSUES RAISED BY PROPOSAL TO GRANT COST OR MARKET OPTION WITH LIFO

6 Nat'l. Tax J. 52, 58–59 (1953)
(Reprinted by Permission)

In the early days of the income tax, the lower of cost or market convention for valuing inventories in conjunction with FIFO procedures was permitted by administrative ruling. The convention, as a practical rule of thumb, had been generally accepted for business purposes. Since the extent of recoverability of inventory costs in future periods can only be guessed, these earlier costs are compared with current market prices and the lower figure taken for the final inventory of a period and for subsequent reckoning. Any excess of cost over market is charged off against current income.

The strict propriety of this convention might be questioned since it uses transitory market prices to provide for losses which have not been, or may never be, sustained. In income tax procedure it is an anomaly "as a concession by the Treasury from a strict realization criterion. In its asymmetry it is obviously biased against the Treasury, since it permits deductions of unrealized losses while not permitting or requiring the corresponding recognition of accrued gains." [1] These features, however, seem comparatively unimportant. The convention serves traditionally conservative objectives of keeping inventory figures in the balance sheet current during price declines. And its effect on income is essentially one of short run variations in timing.

The proposed extension of the cost or market convention to LIFO procedures is open to more serious objection, in fact their combination appears incongruous. LIFO advocates have been willing to subordinate meaningful balance sheet valuations to obtain what they regard as a better measure of income, *i e.*, generally one achieved by stating revenues and costs more nearly in terms of the same price level. Nonetheless, many accountants hold that the use of LIFO for business purposes does not warrant showing inventory at a figure above market valuation. When prices decline and LIFO inventory costs exceed market, it is recommended that the cost figures should be written down to market, even though this writedown violates the above criterion for measuring income.

The effect of combining the cost or market convention with LIFO is quite different from combining it with FIFO. The latter combination may distort the timing of income from period to period as compared with a simple FIFO procedure, but over a series of periods these differences tend to be evened out. With the convention and FIFO, a price decline below costs at the end of a period will result in a reported inventory loss — a reported loss which anticipates a loss actually to be realized in a subsequent period if prices remain down,

[1] Simons, H. C, *Federal Tax Reform*, Chicago, University of Chicago Press, p. 103.

or a reported loss which will be offset by higher reported profits if prices rebound. With a continuing use of the convention and LIFO, a dip in inventory prices results in reported losses without reporting of subsequent compensating profits. Moreover, a firm with a heterogeneous inventory may report inventory losses even though the aggregate value of its inventory has remained constant or appreciated. Among groupings of inventory items there are commonly diverse price movements. With a dispersion of market prices the lower of cost or market convention recognizes losses for groups in which prices have declined, but LIFO ignores inventory profits where prices have risen. If various inventory groups have different price cycles, losses might be reported in a number of accounting periods although the average market value for the entire inventory does not decline.

Perhaps the downward-only revision of inventory values may ultimately be offset upon complete inventory liquidation. But meanwhile, and perhaps while ownership of a corporation passes through several generations of shareholders, reported income is less than would be indicated by either FIFO or straight LIFO methods.

These results seem quite incompatible with basic tax rules for determining current income and with the essential logic of the LIFO principle of income determination. The fact that in recent proposals only a limited period would be provided for permanent downward adjustment of LIFO costs suggests that even proponents of combining cost or market with LIFO have misgivings as to the propriety of the method.

Section B. Some Problems of Fluctuating Income

1. *Installment Sales*

> *Note:* Section 453 of the 1954 Code, relating to installment sales, is derived, with minor substantive changes, from § 44 of the 1939 Code.
>
> See Regs. 118, Secs. 39.44-1-5.

REVENUE RULING 234
1953–2 C.B. 29

Advice is requested regarding the Federal income tax consequences of an agreement between a publisher and a taxpayer,* who is not an author by profession, for the preparation and delivery of a literary composition by the taxpayer under the conditions described below.

The agreement between the taxpayer-author and the publisher in the instant case provides that the author will complete and deliver within a certain period of time a final manuscript of a literary composition, together with suitable material from which illustrations can be made. Simultaneously with the delivery of such manuscript and materials, the author has agreed to grant and assign to the pub-

* Ex-President Truman. [Ed.]

lisher all rights of every kind in and to the composition, including the right to obtain statutory copyrights thereof and renewals or extensions of such copyrights in the name of the publisher. The agreement indicates the minimum and maximum number of words desired for the composition and the general subject to be covered thereby. The author represents and warrants that he will be the author and sole proprietor of the composition, that the composition will not have been previously published, and that it will not contain libelous or otherwise unlawful material.

The agreement also provides that the price to be paid for the rights in and to the composition is $120x$ dollars. On the date the manuscript is delivered, the purchaser will pay $20x$ dollars to the author and deliver to him four noninterest bearing promissory notes of $25x$ dollars each, maturing in each of 4 succeeding years. The agreement specifically provides that the author shall be an independent contractor and shall not act as the agent of the publisher. It also includes certain elections which permit the publisher to terminate the agreement in the event of a breach of contract by the author or his inability to complete the composition because of death or other disability. The author agrees not to make or permit the publication of any material, which may be considered to be in any material way in competition with his composition, until the expiration of a certain period of time after publication by the publisher.

At the time the contract was entered into, the author received a loan of $10x$ dollars from the publisher. This loan is to be repaid to the publisher on or before a fixed date which is prior to the date of delivery of the manuscript except that in the event of death or incapacity, repayment will be made only under certain specified conditions relating to the receipt of proceeds by the author or his estate from the subject matter of the literary composition.

The primary question to be determined is whether, under the terms of the agreement between the publisher and the author, the transaction constitutes a casual sale of personal property which may be returned on the installment basis under the provisions of section 44(b) [§ 453(b), 1954 Code].

A literary composition is recognized as property in the Internal Revenue Code. See section 117(a)(1) [§ 1221, 1954 Code]. Such property is considered to be personal property. G.C.M. 236, C.B. VI-2, 27 (1927); I.T. 2735, C.B. XII 2, 131 (1933).

Under the provisions of section 44(b) of the Internal Revenue Code, in the case of casual sales of personal property, if the selling price exceeds $1,000, and the initial payments received in cash or other property, other than evidences of indebtedness of the purchaser, during the taxable period of the sale, do not exceed 30 percent of the selling price, the gain realized from such sale may be reported on the installment basis.

Under the installment basis, there is reportable as income in any taxable year only that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

Section 44(d) of the Internal Revenue Code, reads in part as follows:

(d) Gain or Loss Upon Disposition of Installment Obligations.—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the

basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligation if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. . . .

An executory contract to sell is to be distinguished from a sale of property. In the case of *Charles W. Dahlinger* v. *Commissioner*, 51 Fed. (2d) 662, Ct. D. 414, C.B. X-2, 337 (1931) certiorari denied, 284 U.S. 673, involving the question of the year in which a sale was consummated, the United States Circuit Court of Appeals for the Third Circuit in affirming the decision of the Board of Tax Appeals, 20 B.T.A. 176, referred to the following statements applied by the Board of Tax Appeals to show the distinction between a contract to sell and a sale.

A contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price.

A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price. (Williston on *Sales*, vol. 1, sec. 1)

Williston proceeds as follows:

The distinction is often expressed by the terms "executory" and "executed" sales. Whether a bargain between parties is a contract to sell or an actual sale depends upon whether the property in the goods is transferred If it is transferred, there is a sale, an executed sale, even though the price be not paid.

Based upon the above facts, it is held, as follows:

(1) The agreement entered into by and between the author and the publisher constitutes an executory contract to sell a manuscript at a future date. A sale of the manuscript will occur on the date the manuscript is delivered and assigned to the publisher by the author. Such sale will qualify as a casual sale of personalty on the installment basis within the purview of section 44(b) of the Code.

(2) Except as provided in paragraph 3, below, the loan of $10x$ dollars received by the author on the effective date of the agreement will not be subject to Federal income tax.

(3) The loan received by the author and not theretofore repaid, will be includible in the author's gross income as ordinary income in the taxable year in which the agreement is terminated if the author fails to complete and deliver the manuscript on or before the agreed date by reason of his death or disability, and if the publisher elects to terminate the agreement, except that if such termination occurs after the death of the taxpayer the amount of the loan shall be includible in the gross income of the taxpayer's estate as ordinary income.

(4) The payment of $20x$ dollars received by the author pursuant to the agreement upon the delivery and assignment of the manuscript will be the "initial payment" referred to in section 44(b) of the Code. The taxable portion of such

payment, computed in accordance with the provisions of section 44(a) of the Code, will be includible in gross income as ordinary income in the taxable year in which the manuscript is delivered and assigned to the publisher. The loan of 10*x* dollars which the publisher made to the author is not considered to be the "initial payment" for the reason that, on the basis of the facts represented, it is determined to constitute a loan rather than an advance. The repayment thereof is independent of the delivery of the manuscript, for which a separate date was provided, and the loan is required to be repaid whether or not the manuscript is delivered. The only condition under which repayment is not required is the death or other disability of the author prior to delivery of the manuscript, but even in such case the manuscript, or, if not completed, the author's working papers with respect thereto, will serve as security for the loan since the author or, in the event of his death, his estate is required to repay the portion of the loan represented by any proceeds received from the subject matter of the composition involved.

(5) The promissory notes delivered to the author pursuant to the agreement upon the delivery of the manuscript will be "installment obligations," within the meaning of section 44 of the Code.

(6) The taxable portion of payments received by the author in full satisfaction of the promissory notes so delivered to him, as computed in accordance with the provisions of section 44(a) of the Code, will be includible in gross income as ordinary income in the taxable year in which such payments are received.

(7) If any of such promissory notes so delivered to the author are satisfied at other than face value or are sold or exchanged, the excess of the amount realized over the basis of such note will constitute ordinary income computable under the provisions of section 44(d) of the Code, in the taxable year in which such amounts are realized.

(8) If any of such promissory notes so delivered to the author are distributed, transmitted, or disposed of otherwise than by sale or exchange, the excess of the fair market value of such note as of the time of such distribution, transmission, or disposition, over its basis, will constitute ordinary income computable under the provisions of section 44(d) of the Code, in the taxable year in which such distribution, transmission, or disposition occurs. However, if any of such promissory notes are transmitted at his death, no gain on account of such transmission will be required to be reported as income in his final Federal income tax return, provided there is filed with the Commissioner the bond prescribed in section 44(d) of the Code.

(9) The cost of producing the manuscript will constitute the basis thereof for the purpose of computing the gain realized from the sale.

Note

1. Under § 453(a), persons who "regularly" sell personal property on the installment plan may elect to report their profits as the payments come in, even though the property is included in inventory or sells for less than $1,000 and even though the initial payments exceed 30 per cent of the sales price. But a dealer who elects to report income on the installment basis must do so for all installment sales during the year, while in the case of a "casual" sale of personal property the taxpayer has a separate option with respect to each transaction. For an interpretation of the phrase, "a person who regularly sells . . . on the installment plan," see *Davenport Machine & Foundry Co* v. *Commissioner*, 18 T.C. 39 (1952)

2. Note that the installment basis may also be elected for real estate, by both dealers and non-dealers, so long as the payments in the year of sale do not exceed 30 per cent of the selling price.

3. Section 453(b)(1) provides that in the case of a sale that satisfies its requirements the income "may . . . be returned on the basis and in the manner prescribed in subsection (a)," *i.e.*, income is to be reported on each installment payment in the same proportion "which the gross profit, realized or to be realized when payment is completed, bears to the total contract price." It has been held that this does not permit a *loss* on the sale to be spread over the payment period. *Martin* v. *Commissioner*, 61 F.2d 942 (2d Cir. 1932).

4. See Anderson, "The Taxation of Installment Sales Including Section 44(d) Problems," 1953 *So. Calif. Tax Inst.* 341.

MORRISON v. COMMISSIONER

Tax Court of the U. S., 1949

12 T.C. 1178

Opinion.

Johnson, Judge. Petitioners regularly reported on the installment basis profits from their contracts to sell lots, as they are permitted to do by section 44(b), Internal Revenue Code, under regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. They returned as income in the taxable years:

> . . . that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price. [Sec. 44 (a).]

But in respect of certain contracts the purchasers defaulted and, pursuant to the stipulated conditions, all previous payments were forfeited to petitioners, the contracts became null and void, and the purchasers were relieved from all further responsibility. Petitioners, having retained title, reacquired possession of the lots, and computed profit from such transactions by including the total profit percentage of the collection made under contract in the schedule of installment sale profits and then adding as "Gain on Lapses" an additional amount, which we infer represents the cost recovery attributable to collections and perhaps some adjustments. There is no break-down of the figure on the return and it is not described in the stipulation.

By section 39.44–3, Regulations 118, it is provided that if a vendor, returning income on the installment basis, reacquires the property after default by the purchaser, gain or loss is to be computed upon any installment obligations which are satisfied or discharged, regardless of whether or not title to the property had been retained by the vendor or transferred to the purchaser. Such gain or loss is to be measured by the difference between the fair market value of the reacquired property and the adjusted basis of the purchaser's obligations to the vendor. In effect, the vendor is treated as disposing of the purchaser's installment obligation in exchange for the repossessed property. Such a transaction is explicitly taxable under section 44(d), which provides:

> (d) Gain or Loss upon Disposition of Installment Obligations.—If an installment obligation is satisfied at other than its face value . . . or otherwise disposed of, gain

or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized. . . .

The Commissioner has determined that upon repossession after default petitioners' gains are the difference between the fair market value of the lots repossessed — an undisputed figure — and the basis of the extinguished installment obligations, adjusted to eliminate amounts returnable as profits.

It has long been settled that section 44(d) is applicable to a vendor's repossession of property subject to a sale contract under which there has been a default in the payment of required installments. Such was the holding of the Circuit Court of Appeals for the Third Circuit in *Boca Ratone Co.* v. *Commissioner,* 86 Fed.(2d) 9, wherein it appeared, as here, that the vendor had retained title to the property sold and that, after default by the vendee and repossession by the vendor, the vendee was released from any further obligation. In its holding the court reasoned that the installment obligations had been "satisfied" within the meaning of section 44 (d) by the repossession. This decision has been followed, *Walker* v. *Thomas* (C.C.A., 5th Cir.), 119 Fed. (2d) 58; *T. Eugene Piper,* 45 B.T.A. 280; and *Eggerman Investment Co.,* 36 B.T.A. 1196, and, indeed, is reflected in the above described provisions of section 39.44–3, Regulations 118. See T. D. 4832, 1938–2 C.B. 155, approved July 19, 1938.

But petitioners argue that under their contracts no installment obligations of the purchaser existed because the purchaser was always free to default and nothing subjected him to liability for the unpaid balance if he did. If we were here dealing with the taxation of profit under the normal method of computation, this argument would be very cogent. But the installment basis of reporting gains is an optional method of convenience which a taxpayer is permitted to use under regulations prescribed by the Commissioner. Sec. 44(b). Having elected to use it, petitioners are bound by the regulations and by their decision. *Pacific Nat. Co.* v. *Welch,* 304 U.S. 191. The regulations have been held reasonable and the effects of the method in producing tax consequences at variance with those of normal accounting have been sustained. *Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496. Indeed, acceptance of petitioners' view that there were no installment obligations would seem to defeat their right to use an installment basis for reporting gain, for total profit and other factors of computation involve such obligations.

As shown by the holding in *Boca Ratone Co.* v. *Commissioner, supra,* and by the provisions of section 39.44–3 of Regulations 118, a uniform application of the installment basis is intended without distinctions on account of legal technicalities such as transfer of title at time of the sale contract or on completion of the contemplated payments. More recently, the Circuit Court of Appeals for the Sixth Circuit held, in *United States* v. *Eversman,* 133 Fed.(2d) 261, that gain or loss should be computed under section 44(b) by use of the fair market value of the repossessed land, even though the contract for its sale provided that the buyer could default, cancel the contract, and relieve himself of all obligation to make further installment payments by giving specified notice of his intent to do so. Such provisions are substantially the same as those on which petitioners here rely, but the court considered the seller as holding an installment obligation which was disposed of at other than its face value by virtue of the repossession of the land. Petitioners stress as to the contrary the court's statement that "Can-

cellation of a contract is certainly not the equivalent of payment of obligations under it." But this observation was made in holding that the initial payments during the year did not exceed the 40 per cent* maximum requisite for use of the installment basis. The repossessed land was not deemed a payment under the contract, but consideration for disposition of the installment obligations.

In general support of their contention, petitioners assert that the Commissioner in effect has determined a gain on the *acquisition* of property, using fair market value as the measure of receipt, while tax is laid on profit from a disposition. But clearly the Commissioner has not done so. Under the governing regulations, which a taxpayer of necessity accepts in electing use of the installment basis, petitioners' lots are considered as sold when the contract is signed, regardless of contractual provisions which might technically postpone consummation of the sale. And, analogously, where the purchaser lost his rights under the contract by default and petitioners reacquired possession of the lot, they are deemed to have exchanged the purchaser's agreement to pay specified installments, receiving the lot in consideration therefor. The resulting gain is thus derived from a disposition of the customer's agreement to pay installments, and by the regulations its basis to petitioners is the excess of face value over the income returnable if the installments had been paid in full, while the amount received therefor is the fair market value of the lot.

Of course it can be objected that the purchaser's agreement to pay installments could not be enforced after forfeiture, but, as the cited decisions establish, the pattern of gain computation on the installment basis is designed for uniform application. Were this not so, petitioners never held any "obligations of the purchaser" and were not entitled to use the installment basis. But, by choosing it, they elected to consider the purchaser's agreement as an obligation, and, having enjoyed the benefits in returning profit on collections, they can not escape the temporary disadvantage of the consequences of forfeiture. The disadvantage, moreover, is nicely compensated by the increased basis of the repossessed lot, which, on a resale, will yield pro tanto less gain or more loss. . . .

Decisions will be entered under Rule 50.

Note

If the seller had not elected to report income on the installment basis (*i.e.*, if he was using what the court terms "the normal method of computation,") what would be the tax consequences of a repossession of the property? In the *Morrison* case, the vendee was not personally liable for the sales price. Assume that he had been personally liable and had defaulted and that the property was not repossessed (*e.g.*, because the cost of repossessing it would exceed its value). Could the vendor take a bad debt deduction if the balance of the sales price was shown to be uncollectible?

ENNIS v. COMMISSIONER

Tax Court of the U. S., 1951
17 T.C. 465

ARUNDELL, Judge: Respondent has increased petitioner's income for the cal-

* Under § 453(b)(2) of the 1954 Code, the payments (if any) in the year of sale may not exceed 30% of the selling price [Ed.]

endar year 1945 by the sum of $10,871.33 on the ground that the petitioner, who reported her income on the cash receipts method, was required under §§ 42, 111(a), and 111(b) [§§ 451(a), 1001(a) and 1001(b), 1954 Code], to include in her 1945 income the full amount of her one-half interest in the profit realized from the sale of the Deer Head Inn. See also Regs. 118, Sec. 39.41–1. Respondent contends that since the sale is a completed transaction in 1945 the entire profit on the sale is taxable in that year.

We agree that in every practical way the sale was complete in 1945. In that year the vendee went into possession of the property and at the same time assumed all the burdens and benefits of ownership. The purchase price was definitely fixed and the vendee was under an unconditional obligation to pay it under the terms set forth in the contract. *Nibley-Mimnaugh Lumber Co.*, 26 B.T.A. 978, affd. 70 F.2d 843; *Union Pacific Railroad Co.*, 32 B.T.A. 383, affd. 86 F.2d 637.

It does not follow, however, that the entire purchase price in excess of the basis constituted gain taxable in the year 1945. Since petitioner reported her income on the cash receipts and disbursements basis she realized a gain from the sale of property only to the extent that the "amount realized" therefrom is in excess of her basis. Section 111(a). Section 111(b) of the Internal Revenue Code provides that the "amount realized" shall be "any money received plus the fair market value of the property (other than money) received."

Upon the sale petitioner received as a down payment a sum of cash not in excess of her basis for the property, plus the vendee's contractual obligation to pay the balance of the purchase price in deferred payments extending beyond the year in question. This contractual obligation cannot be considered an "amount realized" unless it is the equivalent of cash. In *John B. Atkins*, 9 B.T.A. 140, we stated: ". . . in the case of one reporting income on the receipts and disbursements basis only cash or its equivalent constitutes income." This basic rule has been consistently followed. . . .

In determining what obligations are the "equivalent of cash" the requirement has always been that the obligation, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce. See *Dudley T. Humphrey*, 32 B.T.A. 380, wherein we held that non-negotiable promissory notes are not the equivalent of cash and *cf. S. L. Meyer, Executor*, 23 B.T.A. 1201; *Harold W. Johnston*, 14 T.C. 560; *C. W. Titus*, 33 B.T.A. 928; *Perry* v. *Commissioner*, 152 F.2d 183. This principle was recently reiterated in the *Johnston* case wherein we held that a cash basis taxpayer realizes no income when he receives upon the sale of property a promise to pay contained in a contract of sale that

> merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as part of the purchase price.

In the case before us the promise to pay was merely contractual; it was not embodied in a note or other evidence of indebtedness possessing the element of negotiability and freely transferable. It is true that the contract possessed many elements of a mortgage, *Corpus Juris*, vol. 66, sec. 1080, p. 128; Tiffany, *Real Property*, 3d ed., vol. 1, sec. 308, p. 535; . . . but this characteristic does not lend to the contract the necessary element of negotiability. *Cf. Bernard Realty Co.* v. *United States*, 188 F.2d 861.

We conclude, therefore, that the contractual obligation was not the "equivalent of cash," and the only "amount realized" by petitioner on the sale of the property in 1945 was the sum of cash received. Since this sum was not in excess of petitioner's basis for that property no gain was realized on the sale in 1945.

Reviewed by the Court.

Decision will be entered under Rule 50.

Turner, J., *dissenting*: I am unable to reconcile the conclusions reached in this case with the contrary ruling which has long been settled law in cases where a vendor of real estate, in addition to the simple individual liability to pay, receives as further security a mortgage on the property sold. While there are form and technical differences in the two types of transactions, they are for practical purposes substantially similar. In each instance, the vendee is regarded as the owner of the real estate, and in each instance, the land may be sold, devised, or encumbered by him, and on his death descends to his heirs subject only to the mortgage or land contract. In the case of land contracts, see on this point *Bowen* v. *Lansing*, 219 Mich. 117, 88 N.W. 384. The purpose of both the land contract and the mortgage is to secure payment of the balance remaining of the simple or personal obligation to pay. For a land contract case, see *Walker* v. *Casgrain* 101 Mich. 604, 60 N.W. 291. It is true that in the land contract cases there is no transfer of legal title until full payment is made, but the vendor holds legal title in trust for the purchaser pending such full payment. *Hooper* v. *Van Husen*, 105 Mich. 592, 63 N.W. 522; *City of Marquette* v. *Michigan Iron & Land Co.*, 132 Mich. 130, 92 N.W. 934. For other cases which seem to establish the similarity in over-all effect between mortgages and land contracts, see Harold R. Smith, 39 B.T.A. 892; *Title & Trust Co.*, 33 B.T.A. 25; *Barnard* v. *Huff*, 252 Mich. 258, 233 N.W. 213; *Chicago Boulevard Land Co.* v. *Apartment Garages*, 245 Mich. 448, 222 N.W. 697; and *Conners* v. *Winans*, 122 Misc. 824, 204 N.Y.S. 142. And finally, both mortgages and land contracts are regularly sold, traded and assigned. Probably the most noticeable difference between the two is geographic. In Michigan, for instance, the use of the land contract, rather than the mortgage, appears to be the method commonly followed in making real estate sales. We should where possible avoid one rule of law for one part of the country and a different rule for other sections.

Harold W. Johnston, *supra*, relied on by the Court herein, is in my opinion an entirely different case. There the property sold was corporate stock and the selling price had not even been and could not be fixed and determined in 1942, the taxable year. Furthermore, the discussion therein as to property received would, it seems to me, bring this case more nearly in line with the land mortgage cases than otherwise.

Opper, J., *agrees with this dissent.*

Note

If the taxpayer had performed services for which payment was to be made in installments and if he received negotiable instruments to evidence the obligations, would he be taxed on the fair market value of the instruments? Or, being on the cash basis, would he recognize income only as the installments were paid? If so, why is the seller of property treated differently?

Although the Tax Court implies that negotiable instruments are the equivalent of cash, it has not always so held. Thus, in *Fidelity Savings and Loan Co.* v. *Commissioner*, 44 B.T.A. 471 (1941), despite the receipt of negotiable notes secured by a mortgage as evidence of liability for the price, a vendor of real estate was permitted to defer the recognition of income until the installments were collected. The Court found that the notes had no fair market value, apparently because the down payment was very small so that the chance of default was substantial (though there was no finding that the land was worth less than the sales price) and because the taxpayer could sell the notes only with the consent of the state banking authorities. Moreover, under the state's regulations the taxpayer was allowed to recognize income only as the installments were paid.

C. W. TITUS, INC. v. COMMISSIONER

Board of Tax Appeals, 1936
33 B.T.A. 928

TRAMMELL: This case has been reconsidered in so far as it relates to the taxable gain for 1926 derived from the sale of oil and gas leases in that year. After reconsideration we think that we were in error.

The petitioner entered into a contract in writing with the Tidal Oil Co. on February 27, 1926, the pertinent portions of which are as follows:

> THEREFORE, for and in consideration of the sum of one dollar ($1.00) and other good and valuable considerations in hand paid by second party, (Tidal Oil Co.) the receipt whereof is hereby acknowledged by first party, and the mutual covenants and agreements hereinafter contained, IT IS UNDERSTOOD AND AGREED by and between the parties hereto as follows: . . .
>
> Upon the approval of said titles and the execution and delivery to second party of the assignments, conveyances, orders and other papers referred to in the preceding paragraph, second party will pay to first party, as consideration for said properties, the sum of two million dollars ($2,000,000), payable as follows:
>
> $500,000.00, in cash, upon the approval of titles and delivery of the papers above referred to;
> $500,000.00 on or before September 1, 1926;
> $500,000.00 on or before March 1, 1927; and
> $500,000.00 on or before September 1, 1927.

Titus agreed to furnish abstracts to the property described in Exhibits A, B, C, and D, that is, the leases, within 10 days from the date of the contract. Upon approval of titles by the attorneys for the Tidal Oil Co., Titus was to immediately execute and deliver proper assignments, together with orders on the pipe line companies which might have been running the oil from said properties, and such orders and other papers as might be required or might be necessary in order to obtain the approval of the Secretary of the Interior of the assignments covering the oil leases from the Osage Indian Tribe, and when these things had been done the purchaser agreed to make the payments. . . .

In the previous opinion we held that a taxpayer keeping its books and records on the accrual basis is required to report the income represented by the deferred payments, regardless of the fair market value of the deferred payments. We also held that the petitioner had failed to show that the obligations in controversy had no fair market value or a fair market value less than the amount of the face thereof. We now think that we were in error in holding that the fact that the taxpayer kept its books on the accrual method of accounting was determinative

of the issue, and also think we were in error in holding that there was no evidence that the deferred payments did not have a fair market value.

The regulations of the Commissioner, approved by the Secretary, under the Revenue Act of 1921 and all subsequent revenue acts have provided in the case of the sale of real estate on a deferred payment plan, not on the installment basis, where the obligations received by the vendor have no fair market value, that the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and any excess of such basis shall be taxable to the extent of the excess, and that gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis above mentioned and the amount realized therefor.* These regulations have met the approval of the courts in the following cases· *Burnet* v. *S. & L. Building Corporation,* 288 U.S. 406; *Waukesha Malleable Iron Co.,* 67 Fed.(2d) 368; *Commissioner* v. *Moir,* 45 Fed.(2d) 356; and were followed by the Board in *Woodmar Realty Co.,* 17 B T.A. 88. . . .

The Board has decided many cases of deferred payment sales of realty and casual sales of personal property without considering on what method the taxpayer kept its books. . . .

In view of the foregoing, it is our opinion that a taxpayer which keeps its books generally upon the accrual basis has the right to report and have its income computed upon the basis of the deferred payment plan not on the installment basis as provided in the regulations. In this case the respondent has raised no question as to this. The only real question is whether the deferred payments had a fair market value. The Commissioner contends that they did have. The question of the accrual basis was interjected by the Board and we now think that we were in error in doing so.

On the question of the fair market value of the deferred payments not represented by notes or other obligations of the purchaser, the Bureau ruled in G.C.M. 1387 (VI-1 C.B. 48) that in a case of a casual sale of personal property like a sale of real estate on the deferred payment plan, not on the installment basis, where the deferred payments are not represented by notes or other obligations of the purchaser, the cash received by the taxpayer should be applied against and reduce the basis of the property sold, and if it is in excess of such basis, the excess should be reported as a profit. When the deferred payments are received they should be applied against the reduced basis if the initial payment was not in excess of the basis, and the excess over the reduced basis or the total amount received, as the case may be, should be included in income for the year received.

This ruling was modified in G.C.M. 3350 (VII-1 C.B. 62), wherein it was stated:

> The conclusion reached in that memorandum (G.C.M. 1387) should be limited to cases in which the facts are similar to those therein considered where there is involved only a preliminary contract of sale such as is not ordinarily sold or dealt in and which can not be said to have any fair market value.

In the case at bar the only instrument in writing evidencing the fact that the future payments were to be made was the executory or preliminary contract, for the making of which the purchaser did not pay anything, and the obligation

* Regs. 118, Sec. 39.44-4(c). [Ed.]

to make any payments did not arise until later during the taxable year when the petitioner had carried out the terms thereof. . . .

In the case of *Charles C. Ruprecht,* 16 B.T.A. 919, we held as follows:

> We do not consider, however, that the respondent's views with respect to the deferred payments are correct, for the reason that the obligation of the Standard Oil Co. to pay was not so evidenced that it could have been converted into cash, the only record thereof being in the deed of conveyance signed by the grantors. . . . In short, the obligation of the Standard Oil Co amounted to nothing more than a mere non-interest-bearing account receivable.

We held in that case that the deferred payments to be made by the Standard Oil Co. did not have a fair market value and the Court of Appeals, in 49 Fed. (2d) 458, affirmed our decision. . . .

In the case of *Beddell* v. *Commissioner,* 30 Fed.(2d) 622, the court said:

> But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. Section 202(b) of the Act of 1918 provided for an exchange of property and made the profit depend upon "the amount of its (the property received) fair market value, if any"—a phrase which was amended in the law of 1921 . . . to "readily realizable market value." There is a difference between the two, but it is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair Such rights are sold, if at all, only by seeking out a purchaser and higgling with him on the basis of the particular transaction Even if we could treat the case as an exchange of property, the profit would be realized only when the promise was performed. . . .

In the case of *A. W. Henn,* 20 B.T.A. 1133, the petitioner sold certain leaseholds. He had an interest with another person. There was a contract in writing between the vendors which provided that the vendee should assume certain obligations of the third party to the vendors and should pay that obligation, $10,000 in cash, $10,000 in 60 days, $10,000 in 120 days, and $12,441.41 in 180 days, the deferred payments to draw interest at 6 percent. The vendor agreed that upon completion of the payments he would transfer and deliver the property to the purchaser. This contract was entered into in 1923. We held that only the cash received in 1923 was taxable in that year, and the cash received in 1924 was taxable in that year. We said:

> The evidence is that no promissory notes or other evidences of indebtedness were received from the 1600 Prospect Co. in connection with the transaction under consideration. . . .
>
> The assumption and payment by the George W. Stone Co. of the 1600 Prospect Co.'s indebtedness to the petitioner was the consideration for the assignment of that indebtedness and the transfer of 50 shares of common stock of the 1600 Prospect Co. by the petitioner to the George W. Stone Co. Thus it appears that as the indebtedness was paid by the George W. Stone Co., there was a realization upon (1) the indebtedness of the 1600 Prospect Co. amounting to $42,441.41 ($41,487.29 assumed indebtedness of the Prospect Avenue Account and interest of $954.12), and (2) the selling price, if any, of the 50 shares of stock of the 1600 Prospect Co. . . .
>
> Based upon the evidence and the admissions of counsel for the respondent at the hearing, there are findings of fact that the net incomes reported by the petitioner in his returns for 1923 and 1924 were computed upon the cash receipts and disbursements basis, and that the respondent's determination of deficiencies for those years is based upon net incomes computed upon the same basis. Under these findings, it is clear that the respondent erred in holding that the entire profit from the sale of the Hatch and

Dagleisch leaseholds was realized in 1923, because a substantial part of the consideration involved in that transaction was not received until 1924. . . .

In the case of *Dudley T. Humphrey*, 32 B.T.A. 280, there was evidence that the nonnegotiable promissory notes did not have a fair market value. This evidence consisted of the testimony of the petitioner, himself, to the effect that the notes received were nonnegotiable and, being nonnegotiable, did not have any fair market value. On the other hand, financial statements were introduced showing that the purchaser, that is, the maker of the notes, had net assets in excess of the amount of the notes even by using the book values of the securities owned by the purchaser, which had greatly increased in value. The basic evidence in the case as to the fair market value of the notes consisted of the fact that the notes were nonnegotiable, and, being so, had no fair market value. We said "A mere promise to pay in the future which is not accepted in payment, but only as an evidence of indebtedness, is not ordinarily the equivalent of cash," and the *Bedell* case *supra*, was cited and relied on. Here the contract itself obviously only represented the evidence of the indebtedness and was not, itself, accepted in payment for the property.

In none of the foregoing cases was there any evidence introduced directed to the question of the fair market value of the promise to pay, except in the case of *Dudley T. Humphrey*, *supra*, discussed above.

In all of the court decisions above discussed the courts took the position that, when evidence was introduced showing that the deferred payments were evidenced only by contract, where no notes, bonds, or other evidences of indebtedness other than the contract were given, such contract had no fair market value, and that the amounts of the deferred payments should be included in income when received. In the *Ruprecht* case, *supra*, the only evidence of the deferred payments was contained in the deed of conveyance. Based on this finding we held that the deferred payments did not have a fair market value. Our conclusion was based on the fact that the vendor had nothing that he could take to anyone to sell; he had nothing except an account receivable. In this case, while the petitioner had a written contract, there was nothing in the contract itself to indicate when, if ever, the purchaser would become bound to make the payments. To show that the purchaser had become bound to make the payments would have required extrinsic evidence. There were certain things required to be done by the vendor under the terms of the contract before the delivery of the deed or before the vendor was obligated to accept it. Evidence of delivery and acceptance of the deed was a *sine qua non* to any liability. When this was established there would have been a prima facie obligation to make the full payment as provided in the contract, yet an assignee would have been entitled to know beyond a prima facie case that all the obligations of the purchaser had definitely arisen, that is, that all titles were good, all transfer orders were made, approval of the Secretary of the Interior secured as to the leases from Indian tribes, and other things required had been done. After the delivery of the deed there was still an accounting to be had between the vendor and vendee for all the oil produced since the execution of the contract, and other adjustments were required. In any event, the petitioner, itself, after the delivery of the deed, was possessed of nothing in writing to show that it had fully complied with the executory or preliminary contract to make it obligatory on the purchaser's part to make the

payments, except possibly its books and records, which would show the account receivable, but the record is silent as to whether any liability was ever shown on the books. We think, therefore, that the principle of the *Ruprecht* case, *supra*, as well as the court decisions and other Board cases herein referred to, are applicable in this case. . . .

In order for the petitioner to be able to convert the promise to pay into cash it would have had to produce and deliver to a purchaser the evidence of liability to pay. Only a conditional or contingent liability is shown by the instrument itself. The real liability in this case could be shown only by oral testimony, and, while we have assumed from the record that the sale was consummated in 1926, there is no direct and conclusive evidence to that effect. An obligation to pay in the future which depends so largely on oral evidence to support it, in our opinion, can not be said to have a fair market value, aside from the reasoning of the courts and the Board as to written contracts, and in this case, even after the sale had been consummated, there was still an accounting to be had for oil produced since the making of the executory or preliminary contract. The purchaser would have had an offset for an undetermined amount after the delivery by petitioner of all papers required to be delivered until such time as petitioner fully settled on the basis of such accounting. This fact, in connection with all the facts and circumstances, convinces us of the lack of any fair market value of the deferred payments.

Upon reconsideration, therefore, it is our opinion that the petitioner had the right to include in its taxable income for 1926 only the cash received. Petitioner had the right to have his tax computed upon the basis of the deferred payment plan, not on the installment basis. We think we were in error in our previous decision and it is, therefore, modified in accordance with the opinion herein.

Judgment will be entered under Rule 50.

Note

How does the transaction in this case differ from the ordinary sale on open account, the income from which must be reported by the accrual basis taxpayer when the sale occurs? In *Johnston and Johnston* v. *Commissioner*, 14 T.C. 560 (1950), the court made the following observations about the difference between the cash receipts and disbursements basis, and the accrual basis:

> An agreement, oral or written, of some kind is essential to a sale. If payment is made at the same time that the obligation to pay arises under the agreement, then the profit would be reported at that time no matter which method was being used. However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system. (14 T.C. at 565.)

Can these remarks be reconciled with the treatment of the taxpayer in the *Titus* case?

The *Titus* case was concerned with a sale of real property for deferred payments, not on the installment plan. (The "initial payments" of $1,000,000 in 1926 exceeded the critical figure 25 per cent (now 30 percent) of the sales price.) See Regs. 118, Secs.

39.44–2 (b) (2) and 39.44–4. Is similar tax treatment permissible for sales of real property that could qualify under § 44(b) if the vendor does not elect to avail himself of the installment method? What is the relation of the *Ennis* case, *supra*, p. 699, to deferred payment sales? See Desmond, "Sales of Property Under the Deferred-Payment Method," 32 *Taxes* 40 (1954).

2. *Long-term Contracts*

ROLNIK
TAX PROBLEMS OF CONSTRUCTION CONTRACTORS

9th Annual N. Y. U. Inst. on Fed. Taxation 925, 925-929 (1951)
(Reprinted by Permission)

Accounting — General.

For United States income tax purposes, a contractor may report income on all contracts on the cash or accrual basis, although the cash basis is not permitted where it is necessary for the contractor to use inventories. In addition, on *long-term* contracts, the contractor may adopt either the completed contract basis or percentage of completion basis.

Long-term contracts are defined in the Regulations as "building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." It must be borne in mind that the fact that a contract extends over two taxable years does not necessarily make it a long-term contract.

The contractor must be consistent in his method of reporting all his long-term contracts. In other words, the election may not be applied to selected long-term contracts, but must be to all. Furthermore, the contractor must keep his books in accordance with the basis adopted.

The election to use either the percentage of completion basis or the completed contract basis must be made at the time of filing the first return of the contractor. Any change in method of reporting income from long-term contracts may be made only after securing the consent of the Commissioner. . . .

Percentage of Completion Basis.

Under the percentage of completion basis, the gross income for any year is determined by apportioning thereto such part of the total contract price as the work completed that year bears to the total work to be performed under the contract. The Regulations require that the tax return be accompanied by certificates of architects or engineers showing the percentage of completion.

There should be deducted from the reported gross income, all expenditures made during the taxable year on the contract, account being taken of the materials and supplies on hand at the beginning and end of the taxable period for use in connection with the work performed under the contract but not yet applied.

On final completion of the contract, there will usually be a difference in each year's income due to over- or under-estimating the percentage of completion. Under prior Regulations, if upon completion of a contract it appeared that the taxable net income for any year or years had not been clearly reflected by the

percentage of completion method, amended returns were permitted or required. This is no longer in the Regulations.

Completed Contract Basis.

The gross income on the completed contract basis is reported in the taxable year in which the contract is finally completed and accepted. All the costs and expenses applicable to the contract are deferred until the contract is completed. Not only the gain, but the loss is deferred until such time.

Where a contract covers more than one unit, for example a number of ships, the completed contract basis requires that the entire gross income be reported in the year the last unit is completed. If the contractor wishes to report the gross income on each unit as it is completed, he may not use the completed contract basis. A series of independent contracts may not be treated as a single contract.

Where a corporation, on a completed contract basis, is liquidated before the completion of a contract, the profit on the completed portion must be reported in the year of such liquidation, exactly as if the corporation were on the percentage of completion basis.

Importance of Date of Completion.

The date of completion is an important date. In the first place, it determines whether a contract is a long-term contract and, if so, determines whether the contractor may use either the percentage of completion basis or the completed contract basis. In the second place, it determines the year when the income on the completed contract basis is to be reported.

Substantial completion and acceptance is sufficient. Thus, a contract is deemed to be completed and accepted when the architect's certificate authorized final payment and the customer took possession, even though a small amount was withheld by the customer to cover adjustments due to minor defects, and he officially accepted the work in the following year. Where a constructed machine has to be assembled and tested, the date of completion and acceptance is deferred until such time, even though the contractor received payment and shipped the machine in the previous year. The guaranteed period of maintenance by the contractor does not delay the completion date.

Costs and Expenses.

As previously stated, on the percentage of completion basis or completed contract basis, there must be deducted from the gross income reported on a contract in the taxable year all the costs and expenses applicable to the contract gross income of that year. There is usually no problem with regard to the treatment of such overhead items as repairs, depreciation, rentals of equipment, bond premiums, insurance premiums, and casualty and other losses, which are directly applicable to the contract. It is still unsettled whether such items as general and administrative expenses, interest, and taxes may be deducted in full in the year paid or incurred or be apportioned in part to uncompleted contracts at the end of each year. The Commissioner requires depreciation on items of equipment not used exclusively on any particular contracts, and salaries of officers and employees whose services are not definitely connected with the completion of any

particular contracts, to be deducted in the year paid or incurred. However, in a number of cases, taxpayers were permitted to allocate interest, franchise taxes, travel, and office expenses to uncompleted contracts on an approximate estimate basis.

There must be taken into account any materials and supplies charged to the work under the contract but remaining on hand at the end of the year, as well as the value of all unfinished work. Inventories may be valued at cost or market, whichever is lower, as may be elected by the taxpayer, and must be consistently valued. Account must also be taken each year of the deferred charges applicable to future years, for example, unexpired insurance and prepaid rent. . . .

Note

Brown & Root v. *Scofield*, ¶ 72,492 P-H Fed. 1953 (W.D. Tex.), involved a construction company that employed the completed contract basis for reporting income. Its practice was to deduct in the year of completion costs that were "directly related" to a given contract but to deduct its "general costs of doing business" in the years they accrued. The Commissioner asserted that costs in the latter category must be allocated among the company's contracts and deducted in the years of completion, along with the direct costs. The court held that there was no way to allocate the indirect costs accurately and upheld the taxpayer's accounting method.

See Strain, "Contractors' Accounts," 71 *J .of Acc'y* 308 (1941).

3. *Lump Sum Compensation*

Note: **Sections 1301-1304 of the 1954 Code, relating to certain types of lump sum compensation and other payments, are derived, with several substantive changes, from § 107 of the 1939 Code.**
See Regs. 118, Secs. 39.107-1-3.

LOEW v. COMMISSIONER

Tax Court of the U. S., 1952
17 T.C. 1347, aff'd p.c., 201 F.2d 368 (2d Cir. 1953)

Petitioner by this proceeding brings in question respondent's determination of a deficiency in income tax for the year 1944 in the amount of $904 07. The deficiency results from respondent's determination that legal fees in the amount of $3,500, received by petitioner as attorney for the estate of a decedent in the taxable year were not subject to section 107(a), Internal Revenue Code.

Findings of Fact

Some of the facts have been stipulated and are found accordingly.

Petitioner is an individual residing in the village of Floral Park, New York, His income tax return for 1944 was filed with the collector of internal revenue for the first district of New York.

Petitioner is an attorney at law regularly engaged in practice at Floral Park.

Theresa Wicks died a resident of Nassau County, New York, on January 2, 1939. Under her will, which was admitted to probate by the Surrogate of said county on January 10, 1939, petitioner and Clifton R. Engler were appointed executors.

Petitioners also acted as attorney for the executors and rendered various legal services to the estate of Theresa Wicks from January 10, 1939, to June 22, 1944.

By petition dated October 7, 1940, petitioner applied to the Surrogate of Nassau County to determine the compensation to be paid petitioner as attorney for the executors from January 10, 1939, for legal services which were set out generally, but in some detail in the petition and for which petitioner claimed the reasonable value to be $6,000. No separate charges were made for the various items described, but a lump sum was claimed for all.

On February 13, 1941, the Surrogate directed the executors to pay petitioner the sum of $5,000 as compensation for services rendered to and including October 7, 1940. Petitioner received the $5,000 in 1941.

The estate was not closed and petitioner continued to perform legal services for the executors. On April 4, 1944, petitioner filed a second petition for allowance of fees, again setting out generally, but in some detail, the services rendered by him since October 7, 1940, and asking that $3,500 be paid therefor. No specific charges were made for the various items set out. A lump sum was claimed.

Under date of June 22, 1944, the Surrogate decreed that the executors pay petitioner the sum of "$3,500, as and for the balance of his services as attorney for the executors up to and including the decree upon this accounting." This decree contained a recital preliminary to the above, as follows: "the Surrogate having rendered a decision in writing granting the said ALFRED J. LOEW [petitioner here] an allowance of $8,500 for all services rendered to the executors to and including this accounting, less $5,000 theretofore paid, leaving a balance of $3,500." The sum of $3,500 allowed by this decree was paid to petitioner in 1944.

In the statement accompanying his deficiency notice respondent explained "that the fee of $3,500.00 received from the Estate of Theresa Wicks, deceased, for legal services, does not constitute income subject to the provisions of Section 107 of the Code."

OPINION

TIETJENS, Judge: Petitioner's theory in claiming the benefits of section 107 is that his services for the estate during the period October 7, 1940, to April 4, 1944, are to be treated separately from the services for the period beginning with his appointment as attorney and extending through October 7, when he filed his first petition for the allowance of fees. The $5,000 he received for the services rendered during the first period, argues petitioner, is not to be added to the $3,500 for the second period services. Thus he would avoid the 80 per cent provision of the statute.

On this theory petitioner hopes to escape the effect of *Ralph E. Lum*, 12 T.C. 375, and the cases which have followed it. Those decisions, according to petitioner, went the way they did because there was nothing in the records "to permit the segregation of any part of the services," quoting *William J. Morrison, Jr.*, 12 T.C. 709, 713.

We do not think those decisions are to be so narrowly interpreted. Here, petitioner was acting as attorney for an estate over a period of four and a half years. He gave attention to a number of legal matters, separate matters to be sure, but all involving the business of the estate. There was nothing in his employment requiring him to file petitions for the allowance of fees at any particular time. So

far as the record goes, he could do this at times to suit his own convenience. When he did do so he set out the matters for which he was charging generally, but in some detail, and made a lump sum charge for the aggregate. As stated in the *Lum* decision, *supra*, at page 379:

> In the case of services of a homogeneous nature and covering a continuous period, it took more in the *Nast* [*Julia C. Nast*, 7 T.C. 432] case than the mere rendering of a bill to mark the beginning of the period of services, just as here it takes more than the rendering of an account to mark their end.

Apparently that would have ended the matter in *Lum* "unless the services themselves were divisible." In considering this phase of the question we think our decisions in *William J. Morrison, Jr.*, *supra*, and *Julia C. Nast*, *supra*, the first involving the fees of attorneys for a receivership and the second fees for medical services extending over a period of years, are controlling. In neither case was the petitioner allowed the benefits of section 107.

Here, petitioner was employed as attorney by the executors in 1939 and continued in that capacity at least through April 4, 1944. He handled whatever legal matters arose during that period involving the estate. On October 7, 1940, he petitioned the Surrogate for an allowance of fees for the aggregate of his services rendered to that date. His employment as attorney for the executors continued, however, and on April 7, 1944, he again petitioned the Surrogate for an allowance of fees, this time for the aggregate of services performed between October 7, 1940, and April 4, 1944. We are of the opinion that in deciding whether section 107 is applicable we must treat his services as extending over the entire period of his employment as attorney for the executors For this purpose we do not think the period of service is to be broken up by the simple expedient of filing a petition for fees. Accordingly, the amount of $3,500 received in 1944 did not amount to 80 per cent of the total compensation which he received as such attorney and petitioner is not entitled to the benefits of section 107.

Decision will be entered for the respondent.

Note

1. Section 1301 of the 1954 Code carries forward the basic principle of § 107(a) of the 1939 Code, but with several amendments, one of which was intended to meet the problem illustrated by the *Loew* case. The Senate Report has this to say (pp. 445-446) of the new term, "an employment," which was substituted for the old phrase, "compensation for personal services":

> The new term "an employment" is a more specific concept and, therefore, more accurately expresses the intended meaning. This aspect of the existing law has been a source of difficulty in determining the particular unit of personal services involved. In order to meet the 36-month requirement there is a tendency to combine various sets of services which in total extend over the required period. Likewise, there is a similar tendency to separate various sets of services in order to meet the requirement that at least 80 percent of the total compensation for all of the services be received or accrued in 1 taxable year. If a taxpayer has already received a substantial payment prior to the taxable year, he may attempt to segregate the prior payment to a different service rendered by him. In order to dispose of these difficulties, this section adopts the term "an employment." The general idea underlying the new term is that the compensation for which tax relief is provided under this section must relate to a particular project on which the tax-

payer worked, such as a particular law case, and not to a set of unrelated services which the taxpayer may have performed for the same person.

The definition of "an employment" is contained in subsection (b) of this section. There, the term is defined to mean an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation for such services is received. This definition will preclude a separation of services relating to a particular project, merely because the taxpayer may have received compensation for such services from different sources. Whether the period over which services are performed includes conference and study time depends upon the circumstances of the case. In general, if the compensation received specifically includes conference and study time, such time is a part of the total period over which the services were performed. The total period of an employment includes, of course, portions of the period during which the efforts of a taxpayer were unsuccessful in effecting the particular result.

For other cases under the 1939 Code, see cases cited by the Court of Appeals on affirming the *Loew* case, 201 F.2d 368 (2d Cir. 1953); *Terrall* v. *Commissioner,* 14 T.C. 572 (1950).

2. The taxpayer has a certain degree of control over the time of payment in circumstances like those in the *Loew* case, and may be able to satisfy § 1301 by carefully timing his applications for compensation. In *Cozzens* v. *Commissioner,* 19 T.C. 663 (1953), the taxpayer sought to bring himself within § 1301 by asserting that in addition to the bunched income actually received by him in a particular year, a further amount was constructively received. The claim was not sustained, on the ground that the conditions for applying the doctrine of constructive receipt were not present.

3. The *Loew* case arose under § 1301. Somewhat similar benefits may be obtained under § 1302 for income from an "artistic work or invention." Why was a separate statutory provision necessary for such income? To qualify under § 1302, the income in the particular year must be 80 per cent or more of the gross income received from the artistic work or invention during the taxable year, all previous years, *and the following year.* Thus the taxpayer will often not know during the taxable years whether compensation (*e.g.,* royalties) qualifies or not, and amended returns will have to be filed if it turns out that the income was sufficiently "bunched" for § 1302. Can this happen under § 1301?

When § 1302 is applicable, the income can be spread over not more than 60 months in the case of an invention and 36 months in the case of "artistic work" (before 1954, the period was 36 months for both), whereas under § 1301 the income can be spread back over the entire period during which the work was done. On the other hand, as a result of a 1954 amendment, the work on the invention or "artistic work" need have covered a period of only 24 months, rather than 36 months. Section 107(b) raises some intriguing questions about when an artist or inventor commences work—what if a poet's entire life was the preparation for one feverishly completed sonnet? *Richardson* v. *Commissioner,* 14 T.C. 547 (1950); *De Marco* v. *Commissioner,* 9 T.C. 1188 (1947).

4. Section 1303 affords tax benefits to "back pay" that is bunched because of such events as litigation, retroactive governmental awards, and violation of labor laws. In *Thompson* v. *Commissioner,* 203 F.2d 820 (4th Cir. 1953), the statutory phrase "any other event determined to be similar in nature," as defined by Regs. 118, Sec. 39.107-3(b), was held to include an amount paid by an employer to an employee after a lawsuit was threatened. See also *Dingwall* v. *Commissioner,* 211 F.2d 921 (2d Cir. 1954).

5. See generally Gordon, "The Scope of Subsections 107(a) and (d)," 4 *Tax L. Rev.* 169 (1949); Tannenbaum, "Recent Developments Under Section 107," *9th Annual N.Y.U. Inst. on Fed. Taxation* 381 (1951); Swartz, "Authors and the Federal Income Tax," 26 *Taxes* 51 (1948).

4. *Loss Carry-overs*

Note: Section 172 of the 1954 Code, relating to operating loss carryovers, is based on § 122 of the 1939 Code, with substantial modifications.

Section 1212 of the 1954 Code, relating to the carryover of capital losses, is derived, without substantive change, from § 117 (e) of the 1939 Code.

See Regs. 118, Secs. 39.122-1 and 117(e)-1.

BUSINESS LOSS OFFSETS

Treasury Department and Joint Committee on Internal Revenue Taxation, 1947, pp. 2–11

III. Purposes of Business-Loss Offsets

A. *Equity Considerations*

In the absence of the loss offsets, the business entity whose net income becomes negative in some periods is not permitted to deduct all the expenses of earning income. To this extent, the tax on net income becomes a tax on capital. The owners of such a firm are discriminated against, because higher taxes are levied on their net income than on the income of owners of businesses with stable income.

B. *Economic Considerations*

1. *To remove impediments to risk-taking*

Without loss offsets, investments in assets with less risk of loss are favored over those in which the risk may be greater. Thus, the absence of loss offsets will reduce the relative investment in risky assets and ventures. Investment in such assets and ventures may be particularly desirable in the economy. Ventures may be risky because they are new firms challenging established ones or introducing new products. If successful, they bring reduced prices in the industry they enter, or may create employment in an entirely new industry. They may be faced with a period of hard sledding and losses in their early years. If losses in this period cannot be offset against income of future periods, the prospective return from the investment is reduced relative to the return connected with a safer haven for their funds.

2. *To increase the countercyclical effect of taxes*

Absence of loss offsets may also contribute to cyclical instability. In years of losses, expenditures will be held to a minimum. The making of these expenditures may be unprofitable when the firm bears their full cost but must pay a tax on the additional income they would bring in. Yet, they might profitably be made if the cost of the expenditure could reduce taxes through loss offsets. . . .

IV. The Offset of Business Losses

The desirability of increased loss offsets is evident from consideration of equity and economic effects, with administrative considerations a negative item. These major questions still remain: (1) In what direction should losses be offset? (2) For how long a period should they be offset? and (3) How should they be determined?

A. *The Direction In Which Losses Should Be Carried*

The carryforward permits losses of one year to be carried forward as a deduction from net income of future years. The carryback permits losses of one year to be carried back as a deduction from net income of past years. The choice, based upon the purpose of loss offsets, must be made between these two devices.

1. *Equity considerations*

The equity problem in the case of corporate income is to define and tax net income as correctly as possible over time so that stockholders in different companies will receive equal treatment. The equity goal clearly is not permitting all losses to be deducted from all income over a *corporation's* life. Since stockholders change, it would mean that some costs incurred and losses sustained by one group of stockholders would be deducted from income received by another group of stockholders. Under no definition of income would this be correct.

It should be recognized, moreover, that most "losses" are forward looking. Most dollars spent by a business enterprise are for the purpose of bringing in future, not past, income, and should, therefore, be deducted from future, not past, income. If all revenue and all expenses were allocated with perfect foresight, losses would arise only when the firm was making "capital" outlays to increase future income. Most "losses" would then be carried forward. A similar conclusion would hold if all expenditures were deducted when made. Carrying losses forward would result in a more correct statement of income than carrying them backward. Income would not be taxed until all capital was recovered.

Under the present concept of taxable income there are three major exceptions to this simple rule. Costs obviously of a capital nature must be spread over the "useful" life of the asset. Changes in the useful life of the asset can then give rise to obsolescence losses which are properly deducted from past, not future, income. A further qualification arises in connection with inventories. Purchases of goods are expensed only to the extent they are not on hand at the end of the year. Most methods of valuing inventories result in an overstatement of income when prices rise and an understatement when prices fall. Resulting inventory losses are directly related to the inventory previously arising. Bad debts, arising from sales of an earlier period, are related to the sales of that earlier period.

It should be noted that, since devices are available to correct most of these aberrations from the simple doctrine, these costs are insufficient grounds for espousal of carrybacks. Increased depreciation, a different method of spreading capital costs, or the carryback of the unrecovered cost of depreciable assets, could adjust for obsolescence. Inventory reserves or last-in-first-out inventory valuations would substantially remove the possibility of inventory losses associated with past income. Accrual of potential bad-debt losses adjusts for this lagged expense.

It would appear, therefore, that the carryforward would be more equitable than the carryback, since it would generally result in a better determination of income. . . .

2. *Economic considerations*

a. *Stimulating new business enterprises.* The carryforward is obviously superior to the carryback in stimuating the entry of new business enterprises. Any initial

losses the new enterprise sustains in order to enter an industry are really capital costs of earning future income. Only by means of a carryforward can they be offset against that income.

Moreover, so long as a carryback is permitted, even if a carryforward can also be made, the new enterprise would be at a disadvantage. If the entry of such an enterprise were followed by sharp competitive warfare which results in losses in the industry, the established company would be able to recoup a portion of its losses from the Government by way of the carryback, but the new enterprise could not. The latter would have to wait for future profits to recover a portion of its losses. Yet the prospect of future profits is made more uncertain because the Government would partially underwrite its competitors.

For the purpose of stimulating the entry of new business units, the carryforward seems clearly preferable to the carryback.

b. *Relative countercyclical effects.* Both carryforwards and carrybacks would have some countercyclical effect. Both would stimulate business expenditures somewhat in periods of losses (depressions) because the oportunity of offsetting such expenditures against taxable income would reduce the cost of the outlays.

The effect of a carryback would be more certain than that of a carryforward. The firm would be sure at the time of making the outlay that the carryback would reduce taxes already paid in prior years. A carryforward would reduce taxes only if profits were realized in future years. Because of the greater certainty of the tax effect, carrybacks might stimulate business expenditures during a period of losses somewhat more than carryforwards. Presumably, however, business expenditures are nearly always made with the expectation that they will result in later profits, and the difference as to certainty of tax benefit is probably not very significant....

It appears that carrybacks may stimulate business expenditures during a depression to a slightly greater extent than carryforwards. It seems unlikely, however, that the difference between carrybacks and carryforwards in this respect will be very great, or that either carrybacks or carryforwards will have an important countercyclical effect.

3. *Administrative considerations*

The carryback is generally more difficult to handle administratively than the carryforward. Under the former, the returns of past years must be kept open Even if they were closed, to be reopened only for purposes of a carryback, a problem would be presented. Compromises are a give-and-take proposition in which a result satisfactory to the Government and the taxpayer is reached. The final result might differ if at the time of making the compromise it were known that a carryback would arise. In many cases, therefore, compromises would be postponed, or an agreement reached which would not have been reached if future events were then known.

The carryforward, on the other hand, requires audit of losses which were previously passed over. If the carryforward period is long, either the statute of limitations must be extended or the rule adopted that a net operating loss deduction represents an election by the Government to waive the statute for the years in question. The audit of losses sustained a considerable period in the past is, of course, difficult.

B. *The Length of Time Over Which a Loss May Offset Income*

In terms of the purposes of loss offsets, there appears to be no theoretical limit to the length of time losses should be carried forward. However, business plans are made, generally, for a relatively short period. The desirable stimulus of loss offsets can be achieved by a period considerably shorter than, say, 10 years. Furthermore, the absence of a theoretical limit to the length of carryforward can be qualified. Future income cannot be clearly foreseen, and unduly long carryforwards might in some cases result in tax reductions that would do no good from the point of view of incentives. This would be the case where the profits of a depressed industry suddenly increased and went untaxed because of the carryforward of losses of years long past. An example of such a situation is the wartime increase in the earnings of railroads after the difficult period of the 1930's.[1] There are serious administrative objections, moreover, to lengthy carryforwards as has been indicated earlier. Some compromise must be made, along the lines of choosing a period which will offset the bulk of losses and yet be administratively feasible.

There are no data conclusively indicating the effectiveness of different periods for offsetting losses. . . .

Since the average business cycle does not appear to exceed about 8 years in length,[2] a five year period would be long enough to allow all losses attributable to general depressions to be applied against income of generally prosperous years. However, a 5-year period might not be long enough to meet the requirements of new firms and of firms whose profits fluctuate over a cycle longer than the general business cycle. . . .

C. *The Kind of Loss To Be Carried Over*

There are two sharply conflicting theories on the question of the kinds of losses and the kinds of income which should be used in calculating the loss offset. One approach is to determine them in the same way as taxable income is determined. This process excludes from the calculation such items as tax-exempt interest and 85 percent of intercorporate dividends which were not used in calculating taxable income or net loss for the purposes of the original tax. It is argued that because they were omitted in that connection they ought not be used in calculating the loss which is to carried over, or net income against which the loss is to be offset.

The opposing view starts with the presumption that a loss offset should not come into operation until a "true" loss has been sustained, *i.e.*, until total net income from tax-exempt securities which can absorb the "loss" in whole or in part. It is only the excess of deductions over total income, including income which is ordinarily excluded from the calculation of taxable income, that should be counted as a loss for the purpose of offsetting income of another period. As a

[1] The net operating loss deductions of transportation and public utility corporations in 1940–42 alone were $236 million as compared with $231 million for the entire period 1922–1932. For no other industry group was there an absolute increase in the size of net operating loss deductions between these two periods With a longer carryforward, the increase in operating loss deductions of transportation and public utility corporations would have been greater.

[2] Alvin H. Hansen, *Fiscal Policy and Business Cycles* (1941), pp. 18–19. Other students focus attention on a cycle of only 40 to 50 months' duration. See, for example, Arthur F. Burns and Wesley C. Mitchell, *Measuring Business Cycles* (National Bureau of Economic Research, 1946), pp. 78, 401, 412.

corollary, it follows that in the year in which this "true" loss is applied, it should be counted against total net income accrued, not merely taxable income. In practice, this means that the taxpayer will have to show a deficit in taxable income in excess of the income which is ordinarily excluded from the calculation of taxable income before any benefit will be received.

While the present law is not a perfect application of either theory, it is drawn primarily in terms of the "true" loss idea. The net operating loss which may be carried over is the excess of allowable deductions (the excess of percentage or discovery-value depletion over cost depletion having been eliminated) over statutory gross income plus net tax-exempt interest and, in the case of individuals, 50 percent of net long-term capital gains. In the case of corporations 100 percent of intercorporate dividends are included in the computation instead of 15 percent as in the ordinary computation of taxable income. In each of the years to which this loss is carried it is reduced by the amount of these same items of exempt income in such years. As a result the income taxed over the period of loss offset is a different kind of income from that which is taxed in a single year.

The existing law falls short of the total-income theory in that total income is understated by the omission of such exempt items as recoveries of certain bad debts, taxes, *etc.*, certain forgiveness of indebtedness, receipts from life insurance policies, military pay and allowances, the surtax exemption for certain preferred-dividend payments of public utilities, and other similar exemptions. The total income used is overstated by the non-deduction of capital losses in excess of gains, and business expenses deemed extraordinary or unnecessary or otherwise not deductible.

Advocates of the taxable-income approach place primary emphasis upon the inconsistency of granting a concession to such items as interest from exempt securities, long-term capital gains, intercorporate dividends, and percentage depletion, in calculating annual taxable income, and not permitting the same concession in determining income over a longer period of time when such income fluctuates. As they point out, this leads to inequities as between taxpayers with fluctuating and stable incomes. Thus, where two mining companies, perhaps direct competitors, have equivalent production and income over a period of time, one will be denied percentage depletion whereas the other will obtain it. Similarly, where two corporations each receive the same amount of dividends from domestic corporations, one must include 100 percent of such dividends as taxable income, while the other need include ony 15 percent. Advocates of the taxable-income approach believe that such discrimination cannot be reconciled with the previously stated purpose of the loss carryover which is to define and tax net income as correctly as possible over time so that different taxpayers will receive equal treatment.

Advocates of the total-income approach point out that the basic purpose of the loss offset—to prevent the taxation of capital as income—is satisfied by this method; that the cancellation of the tax exemption under the total-income theory does not result in the taxation of income at rates higher than the statutory one. Moreover, they hold that whether or not undesirable discrimination results from the total-income approach depends on the standard of comparison. If the taxpayer with tax-exempt income whose income fluctuates is compared with a taxpayer with no tax-exempt income, the law would still favor the former. . . .

Note

1. A number of changes in the operating loss deduction were made by the 1954 Code. The carryback is now for two years, instead of one, but the five year carry-forward period is retained. In calculating the amount of the deduction, the "taxable income" approach discussed in the foregoing extract is accepted to a much greater degree than formerly, and adjustments are no longer required for tax-exempt interest, the excess of percentage over cost depletion, or the untaxed portion of dividends received. Another important change relates to § 172(d)(4). The corresponding provision of the 1939 Code, § 122(d)(5), was construed to prevent the carryover of a loss incurred on the sale of property (*e g.*, a farm or factory) used in the taxpayer's trade or business unless he was in the business *of selling* such property. *Sic* v. *Commissioner*, 177 F.2d 469 (8th Cir. 1949), cert. den. 339 U.S. 913 (1950). As amended, § 172(d)(4) will not prevent a carryover of such a loss.

2. See also Beck, "Carryover of Business Losses," 6 *Nat'l. Tax J.* 69 (1953). In order to increase the usefulness of the § 172 carryback, a taxpayer may file an application under § 6411 for a tentative refund of the previous year's taxes. The application must in general be acted upon within 90 days, but errors disclosed by subsequent audit can be corrected. Moreover, under § 6164 a corporation *expecting* a § 172 carry-back from its operations in the current year may obtain an extension of time for the payment of taxes for the previous year.

3. Many losses that are not within the scope of § 172 can be carried over by reason of the capital loss carry-over of § 1212. Thus, although a capital loss is ordinarily less useful to the taxpayer than an ordinary loss, there are times when a capital loss would be preferable because it could be carried over under § 1212.

There are some items that can never be carried over. Among them are § 212 expenses, non-capital § 165(c)(2) losses, and personal expenses like taxes and interest. Unused personal and dependency exemptions are also unavailable for carry-over.

5. General Averaging Proposals

MAXWELL
AVERAGING FLUCTUATING INCOME OF THE INDIVIDUAL FOR INCOME TAX PURPOSES

20 Wash. L. Rev. 105-111 (1945)
(Reprinted by Permission)

It is a familiar feature of our system of taxation that tax rates be graduated in proportion with the ability of the taxpayer to pay. As income rises, the percentage of tax is increased by the so-called surtax. For the taxpayer with approximately the same income, year after year, an annual imposition of tax according to these rates is equable; but unlucky is the individual who has high income one year and low income the next, for he must pay a substantial amount of tax over and above that which he would have had to pay had his income been level throughout the years, due to the surtaxes in the years of high income.

The present Internal Revenue Code contains several provisions which in some measure alleviate this heavier burden on the individual with the fluctuating income. Substantially, however, the present law has been wrought upon the theory that it "is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals."[1] Thus, at the end of each calendar or fiscal year, the taxpayer must pay a tax based on only the

[1] Security Flour Mills Co. v. Commissioner, 321 U. S. 281.

profits and losses of that year, necessitating the use of the yearly accounting system, unless he comes within one of the special provisions. The "back-pay" section, the provisions allowing a "carry-back" and "carry-over" of losses incurred in a trade or business, and the "installment sales" provisions may be cited as examples of the present day allowance of proration of income over several years' time; but these apply only in specific situations and are hedged around with so many conditions that few can take advantage of them. . . . It is proposed herein to examine what can and, if possible, what should be done to ease the burden still applicable to the greater number of taxpayers with fluctuating incomes.

From time to time there have appeared various proposals and suggestions that the individual and other taxpayers should be allowed to average his income over the space of some years, thus eliminating some of the inequities above mentioned. Nor is such a general averaging provision a new concept in the field of the law itself. It has been tested in Australia and Wisconsin, and England has made limited attempts along these lines. Of these it may be said generally that they failed primarily because they were detrimental to state interests. In a word, they went too far and reversed the equities. It should be clear that any effective averaging system will lower government income in some measure. Consequently, tax rates must be raised somewhat to compensate....

While the main advantage of an averaging system in income tax law would be to relieve the unequal burden on the taxpayer with the fluctuating income, it would have other results equally as desirable. The complicated problems relating to shifting of income from one year to another would disappear in large measure, if not entirely, because under an averaging system there would be little incentive. Since a great many of the differences arising between the taxpayer and the government are based on the question of correct allocation of income to a particular year, there would be a great saving in time, money and worry to both parties. Likewise, the special provisions as to certain classes of taxpayers already discussed would be entirely superseded as to individuals, so that it would not be necessary for the taxpayer to walk a worried legal tight-rope in order to bring himself within the special class for whose benefit the provision was enacted. Further, such a provision would eliminate the necessity of the special treatment of capital gains and losses, since the purpose behind these concessions was to be rid of the inequity of a tax based on highly irregular income. It would no longer be necessary to reason that the income derived from a "capital gain" had been accumulating over the years and therefore a certain percentage of the tax should be forgiven due to the pyramiding of surtax rates. In this respect, it also should be noted that some simplification of the individual income tax laws would result, which would be in accord with the present popular movement.

However, inherent disadvantages may be found in every averaging system, both as to the government and the taxpayer. While the law would be simplified in some respects, there is no doubt that further computation would be required from the taxpayer. In addition, his records must be complete for the entire period in order to make such computations, and he would be forced to file a return every year even though no tax is due for that year, in order to have a basis for averaging future gains. This in turn enlarges administrative work; records must be kept, and any controversy would require the checking of all computations for the

period; if an error be found in, say, the first year of the period, subsequent returns would have to be amended since the basis for them would have changed to some extent. Any refund due the taxpayer at the end of the period would be delayed for approximately two years (this being the delay today in "auditing" the returns) even though overpayment was made the first year of the period. Perhaps more important, revenue receipts would be delayed considerably at the end of a depression, due to the accumulation of losses. This would probably have serious economic effect, a discussion of which is not relevant here. Further problems would be found in the taxpayer's change of status during the period, a difficult question under the short annual system today; and also in the removal of the taxpayer from one reporting district to another, with its attendant transfer of records.

In any discussion of averaging, the method to be followed in determining the average will be foremost in importance. Applicable to such a proposal are three methods: the simple average; the progressive average, and the moving average. Each of these presents its own special problems and aids in addition to the general advantages and disadvantages summarized above, and consequently must be discussed separately. In presenting these, periods of equal time duration will be used in examples wherever possible for purposes of comparison. However, it may be said generally that this period may be lengthened or shortened, within reasonable limits, to best reflect the equities and administrative exigencies. If the period is too long, any relief afforded may come too late, and if it is too short, the average will have little validity or effect, and the number of adjustments increased needlessly.

The Simple Average

The simple average, for our purposes, would be an averaging at the end of every, say, four years of the income of the taxpayer within those years, a subsequent determination of the tax as it would have been had the income been steadily received, a crediting of the taxes paid during the three prior years against this, and the result will be the tax due for the taxable year.[2] A surprising resemblance between this method and the collection system lately adopted [1944] can be seen, since under the latter some individuals must file quarterly declarations of estimated tax and make payments accordingly, and the total income for the four quarters determines the final amount of tax due. But as we have seen, the period here is too short. Can it be lengthened?

It has been suggested[3] that this should be done, making it optional with the taxpayer and provided that no year appears in more than one averaging computation. Claims would be limited to those over a certain percentage of tax payments, or over a certain amount; income before filing or after death would be ignored; and the burden would be on the taxpayer to establish his right to a refund. It is said that the loss of revenue to the government in bad years is offset by the readjustment in equity and the added incentives toward risky enterprises.

In one great essential, this method is excellent. The tax is paid annually as heretofore and at annual rates. This enables the taxpayer to pay his taxes when he is able to do so, and apply for a refund (or credit) at a time when his income is low,

[2] See Atlas, "Average Income and Its Use in Taxation," 13 *Accounting Review* 124.

[3] Groves, *Production, Jobs and Taxes*, (1943), pp. 84-86 (Ch. II); *cf.* Atlas cited *supra* note 2.

if the year of averaging were at his election. But an optional method would result in variance of period lengths for each taxpayer: *i.e.*, *A* might wish to average his tax for the last three years only, while *B* might choose to average the last eight years. The result would be a confused administrative staff, a mass of records and extensive bookkeeping. It would therefore be necessary to limit the averaging to a definite period of, for example, the taxable year and the three years preceding, leaving it optional with the taxpayer to average four consecutive years at the close of any year, so long as no year was averaged twice.

Such provision would go far toward elimination of some of the usual objections to the simple average method. The arbitrary choosing of the first year to which the average would apply would result in cries of "discrimination" by those disliking the choice made. More important, such an option would result in staggering the credits over the years, whereas the allowance of such averaging only at the end of every fourth year would result in a great mass of administrative work together with a great loss of revenue due to refunding and crediting in the fourth year. The proposal that such refunds or credits be limited to those over a certain percentage of the tax paid[4] would further eliminate administrative work and loss of revenue, since many of the refunds or credits would be small in amount; but *quaere* as to the policy of this limitation since it would tend to discriminate in favor of a certain group. In any event, crediting such refunds on the returns for the taxable year would eliminate much administrative work.

Under this system, the present problems presented by attempts to shift income would probably not be intensified, but rather subdued, inasmuch as the taxpayer would have no idea what his average income would be in the next period. Of course, he gets the benefit of the credit only once in every four years, being deprived of the use of the amount of overpayment made in the first year; perhaps interest should be added to this refund or credit to compensate, if it would not result in great complication.

Where there is a change of status of the taxpayer, an added difficulty arises. At the present time it is provided that his status shall be determined as of the last day of the taxable year, but this should surely not be extended to four years. Hence, averaging should be confined to net income less all deductions and exemptions, or such deductions and exemptions could be prorated throughout the period. Added difficulties may be found in the community property states, but this system of property ownership should not be allowed to interfere with government revenue to any great extent. A requirement of joint returns from all families should solve this problem.

The simple average, in one form or another, is the one most frequently offered as the simplest method of accomplishing this result, because no revolutionary changes in tax law as it presently exists are necessary and the equities are roughly provided for, even though the average may, and probably will, fluctuate somewhat from period to period. No great conflicts are presented, and "simplification" is even aided somewhat by elimination of various problems occasioned by the annual period.

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[4] Groves, cited *supra* note 3; and see Vickrey, "Averaging of Income for Income Tax Purposes," 47 *Journal of Political Economy* 379

The Progressive Average

In taking a progressive average, a certain period is adopted and then each year within the period the income for that year and the prior years, if any, within the same period is averaged. The tax is then computed as if the average income had been received each year, and the previous overpayment, if any, is credited to the tax due for the taxable year.

William Vickrey, in a well-considered article,[5] advocates the use of this system, and in conjunction therewith develops the concept of "adjusted total income" in order to put all taxpayers on the same tenable footing. In essence this is the total income received during the period plus compound interest on tax payments previously made. Under his proposal, this amount would be computed, the average income within the period which would give this result is determined; the present value of the taxes that would have been payable on such a constant income according to the present methods of assessment and the rates of the various years within the period is then computed; the present accumulated value of the taxes paid during the period is deducted, and the remainder is the tax due.

While more than somewhat complicated, this method of computation does enable the taxpayer with a given total income to stand on exactly the same footing with all other taxpayers having the same total income, regardless of where, during the period, such income was realized. His suggestion is that the duration of the period should be the lifetime of the individual, or at least from majority to death. At the end of the period then, each taxpayer will have paid the same amount that every individual having the same total income and the same life or earning duration will have paid. Thus, the equities would be exactly adjusted, and the government would be in receipt of revenue at the time the income is earned, except in one situation—where tax rates are raised and individual income declines sharply. This would be the occasion for a government "relief" provision, authorizing the use of a supplementary schedule of rates.

It is further proposed that the "complications" be ameliorated somewhat by governmental schedules, similar to those now provided, for each number of years the taxpayer would have been subject to this method. *Quaere* if such a proposal would meet the approval of "simplificationists" today, however.

Hereunder there would be little or no shifting of income problem, and the end and beginning of the periods would be staggered over the years. But in the latter respect, it must be remembered that averaging computations are made every year. In addition, voluminous records must be kept by the government, although perhaps this would not be required of the taxpayer, who could carry the figures over from his last return. The problem of change of status of the taxpayer is not adequately met; suggestions are made that the period be cut on marriage, divorce or death; or separate returns of each member of the family be required; or there be consolidation of family income in one return, and apportionment among the family.

It can readily be seen that such a proposal, while adjusting the present burden on fluctuating incomes with exactitude, would involve wholesale changes in exist-

[5] "Averaging of Income for Income Tax Purposes" cited *supra* note 4.

ing tax law concepts and, in addition, would put an impossible burden on administrative agencies.

The Moving Average

A moving or running average is found by taking, each year, the average of the taxable year's income and the income of a certain number of preceding years, the number of years averaged always being the same. Such a system was utilized in Australia, Wisconsin and, to some extent, in England.

The Australian provision provided for the use of a moving average extending over a period of five years, including the taxable year. The Wisconsin provisions were essentially the same, but for a three-year period, as were the restricted English provisions. No attempt will be made herein to discuss the advantages or disadvantages of these laws,[6] but in general it is agreed that the failure of each of these was due in large respect to the fact that the tax was not collected when the taxpayer was able to pay it; *i.e.*, in the year the income was received. It can easily be seen that, under this method, should a single year of high income be received, with low years stretching on either side, the taxpayer will have but a relatively small amount to pay in the year of high income; but three years thereafter he would have a fairly high tax to pay without benefit of a large income or a large credit from past tax payments. Such a situation is very likely to develop in depression years. However, it might be possible to overcome this difficulty by providing that in cases where the income of the present taxable year exceeds the average income for the averaging period by a certain percentage or amount, a special surtax shall be added to the tax due for that year, subject to refund or credit at the time when such high income year shall be the first year in the period (since, in the subsequent years, the high income year will no longer be averaged), unless the income of any year succeeding such high income year within the period shall be still higher, when such overpayment for the first high year shall be credited to the surtax due for the second high year.

The provision outlined above for use with the moving average would thus remove the major difficulty with the use of this averaging method. However, it is possible that the shifting problem, not ordinarily presented by the use of the moving average, would thereby be revived somewhat. Change of status during the period is not a greater problem than it would be if the simple average were used, and the same solutions, as hereinbefore discussed, should be adequate. But there is a large burden put upon the administrative agencies, since there is an averaging computation each year, although not a complicated one. Records must be kept, but only for the preceding three years (if the total average period is four years); and under various provisions and regulations today old returns may be re-opened and amended for the preceding three years. There will be, of course, the inevitable lag in "audit" by the government, but any averaging system entails this as a necessary evil.

Problems such as corporate dissolution and reorganization have been omitted throughout as this paper has been confined to considerations of individual

[6] For a full discussion of the history and defects of the Wisconsin and English Acts, see Atlas, cited *supra* note 2; and see also Vickrey, cited *supra* note 4, Groves, cited *supra* note 3; H. B. Spaulding, *Income Taxation in Great Britain and the United States*, pp. 211-28.

taxpayers alone, but it might be well to note their existence especially under the moving average, due to their contribution to the downfall of the Wisconsin provisions; however, this is the change of status problem as applied to others than individuals, and therefore should not be insuperable. Taken as a whole, the moving average, while presenting some difficulties, does not deserve the reputation it has received because of its previous failures.

Note

See also Vickrey, *Agenda for Progressive Taxation* (1947) 164-197; Blough, "Averaging of Income for Tax Purposes," 20 *Accounting Review* 85 (1945); Hearings on General Revenue Revision, House Committee on Ways and Means, 83d Cong., 1st Sess., pp. 243-330 (1953).

Section C. The Taxable Year As the Accounting Period

1. *Items in Dispute*

NORTH AMERICAN OIL CONSOLIDATED v. BURNET

Supreme Court of the U. S., 1932
286 U.S. 417

Mr. Justice Brandeis delivered the opinion of the Court.

The question for decision is whether the sum of $171,979.22 received by the North American Oil Consolidated in 1917, was taxable to it as income of that year.

The money was paid to the company under the following circumstances. Among many properties operated by it in 1916 was a section of oil land, the legal title to which stood in the name of the United States. Prior to that year, the Government, also claiming the beneficial ownership, had instituted a suit to oust the company from possession; and on February 2, 1916, it secured the appointment of a receiver to operate the property, or supervise its operations, and to hold the net income thereof. The money paid to the company in 1917 represented the net profits which had been earned from that property in 1916 during the receivership. The money was paid to the receiver as earned. After entry by the District Court in 1917 of the final decree dismissing the bill, the money was paid, in that year, by the receiver to the company. *United States* v. *North American Oil Consolidated*, 242 Fed. 723. The Government took an appeal (without supersedeas) to the Circuit Court of Appeals. In 1920, that Court affirmed the decree. 264 Fed. 336. In 1922, a further appeal to this Court was dismissed by stipulation. 258 U.S. 633.

The income earned from the property in 1916 had been entered on the books of the company as its income. It had not been included in its original return of income for 1916, but it was included in an amended return for that year which was filed in 1918. Upon auditing the company's income and profits tax returns for 1917, the Commissioner of Internal Revenue determined a deficiency based on other items. The company appealed to the Board of Tax Appeals. There, in 1927, the Commissioner prayed that the deficiency already claimed should be increased so as to include a tax on the amount paid by the receiver to the company in 1917. The Board held that the profits were taxable to the receiver as income of 1916; and

hence made no finding whether the company's accounts were kept on the cash receipts and disbursements basis or on the accrual basis. 12 B.T.A. 68. The Circuit Court of Appeals held that the profits were taxable to the company as income of 1917, regardless of whether the company's returns were made on the cash or on the accrual basis. 50 F.(2d) 752. This Court granted a writ of certiorari. 284 U.S. 614.

It is conceded that the net profits earned by the property during the receivership constituted income. The company contends that they should have been reported by the receiver for taxation in 1916, that if not returnable by him, they should have been returned by the company for 1916, because they constitute income of the company accrued in that year; and that if not taxable as income of the company for 1916, they were taxable to it as income for 1922, since the litigation was not finally terminated in its favor until 1922.

First. The income earned in 1916 and impounded by the receiver in that year was not taxable to him, because he was the receiver of only a part of the properties operated by the company. Under Sec. 13(c) of the Revenue Act of 1916, receivers who "are operating the property or business of corporations" were obliged to make returns "of net income as and for such corporations," and "any income tax due" was to be "assessed and collected in the same manner as if assessed directly against the organization of whose business or properties they have custody and control." * The phraseology of this section was adopted without change in the Revenue Act of 1918, 40 Stat. 1057, 1081, c. 18, Sec. 239. The regulations of the Treasury Department have consistently construed these statutes as applying only to receivers in charge of the entire property or business of a corporation; and in all other cases have required the corporations themselves to report their income. Treas. Regs. 33, arts. 26, 209; Treas. Regs. 45, arts. 424, 622. That construction is clearly correct. The language of the section contemplates a substitution of the receiver for the corporation; and there can be such substitution only when the receiver is in complete control of the properties and business of the corporation. Moreover, there is no provision for the consolidation of the return of a receiver of part of a corporation's property or business with the return of the corporation itself. It may not be assumed that Congress intended to require the filing of two separate returns for the same year, each covering only a part of the corporate income, without making provision for consolidation so that the tax could be based upon the income as a whole.

Second. The net profits were not taxable to the company as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. See *Burnet* v. *Logan,* 283 U.S. 404, 413. Compare *Lucas* v. *American Code Co.,* 280 U.S. 445, 452; *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 363. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company's return was filed on the cash

* The current equivalent of this provision is § 6012(b)(3); see Regs. 118 Sec. 39.52-2. [Ed.]

receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive.

Third. The net profits earned by the property in 1916 were not income of the year 1922—the year in which the litigation with the Government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. See *Board* v. *Commissioner*, 51 F.(2d) 73, 75, 76. Compare *United States* v. *S. S. White Dental Mfg. Co.*, 274 U.S. 398, 403. If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare *Lucas* v. *American Code Co., supra.*

Affirmed.

Note

1. Was it the dispute or the receivership that prevented the income from being taxable in 1916? If the former, why was the income taxable in 1917, when the dispute was still alive? If the latter, why shouldn't an accrual basis taxpayer be taxed on the basis of its *rights*, rather than its receipts? (There was no finding as to whether the taxpayer was on the cash or the accrual basis, but if this was relevant, the case could have gone back for a determination of this question.) Would the result have been different if in 1916 the court had denied the application for a receiver but had required the taxpayer to post a bond to secure payment of any judgment that might be entered? Could the taxpayer have protected itself from liability in 1917 by treating the receipt as a trust fund pending outcome of the appeal, *e.g.*, by depositing it in a special account and labelling it as a trust fund on its books? *Commissioner* v. *Alamitos Land Co.*, 112 F.2d 648 (9th Cir. 1940).

2. The receipt of the funds in 1917 means that both the taxpayer and the government will be alert to the possibility that they should be reported then. (If the $172,000 was not reported by the taxpayer, the government would be put on notice of its receipt by Schedule M of the corporate return.) If the court had held that the funds were not taxable until 1922, would there be any formal way in which the government would become aware of the item if it was not reported by the taxpayer? Should disputed items, in other words, be reported not later than the year of receipt lest they be overlooked altogether?

3. The taxpayer, a motor carrier, contracted to transport government property at not more than the lowest rate charged by land-grant railroads between the same points. The taxpayer was advised by the government that because the land-grant rates could not be furnished, it should charge at its regular tariff rates and that the General Accounting Office, on a subsequent audit, would ascertain the correct charge and make demand for the overcharges. This practice was followed. On estimating that the land-grant rates were about 17 per cent below its regular rates, the taxpayer offered to renegotiate the contract on this basis, but the offer was rejected by the government. In computing its taxable income, the taxpayer deducted from gross operating revenues from the transportation of government property an amount of 17 per cent as a reserve for the refunding of overcharges. The amount actually refunded in later years was substantially less. It was held that the only amount that could be excluded from income in the year the transportation occurred, under the *North American Oil* case, was the

amount actually repaid in the later years. *Bates Motor Transport Lines, Inc.* v. *Commissioner*, 200 F.2d 20 (7th Cir. 1952). Was the taxpayer taxed on more than it received under "a claim of right"?

4. See Comment, Taxing Unsettled Income: The "Claim of Right" Test, 58 *Yale L.J.* 955 (1949).

5. Note the statement at the end of the opinion about a deduction in the year of refund if the amount had been repaid by the taxpayer; see also *United States* v. *Lewis*, *supra*, p. 92. Section 1341 provides, in effect, that if the deduction exceeds $3,000, the tax benefit to be derived therefrom shall not be less than the amount of tax attributable to the inclusion of the item in the earlier year. Would § 1341 be applicable to the *Shannonhouse* case, *supra*, pp. 441–2?

Why is an exception made in § 1341(b)(2) for income from the sale of inventory items and stock in trade?

COMMISSIONER v. BROOKLYN UNION GAS CO.

U. S. Court of Appeals, Second Circuit, 1933

62 F.2d 505

Before MANTON, L. HAND, and SWAN, Circuit Judges.

SWAN, Circuit Judge.

The income tax in dispute is that of the Brooklyn Union Gas Company and its five subsidiary corporations for the taxable year 1922. The respondent and its subsidiaries were engaged in the manufacture, distribution, and sale of illuminating gas in Brooklyn and its environs. Beginning with the year 1916, some or all of these companies were continuously involved in rate litigation until the controversies were settled in their favor in 1922. Out of this litigation has arisen a dispute as to the amount of their taxable income for that year. Voluminous findings of fact are set out in the opinion of the Board in 22 B.T.A. 507, and we shall restate them only to the extent deemed necessary for an understanding of the issues here presented.

In the so-called *Rate Cases No. 1* the New York Public Service Commission issued orders in May, 1916, directing four of the subsidiary companies to reduce their rates. Proceedings were immediately instituted in the state court attacking the reduced rates as confiscatory, and an interlocutory order was made staying execution of the commission's reduced rates and directing that moneys collected in excess thereof be impounded in a bank subject to further order of the court. In July, 1919, the excess moneys so impounded were withdrawn by the companies, pursuant to court order, upon the giving of a bond for repayment in the event that the reduced rates should finally be sustained. In August, 1922, the commission abrogated, as of their original date, its orders reducing the rates. The Commissioner of Internal Revenue seeks to tax as income for 1922 the impounded moneys withdrawn in 1919.

In *Rate Cases No. 2* the respondent and its subsidiaries began litigation in 1920 attacking the constitutionality of a New York statute known as the Eighty Cent Gas Law (Laws N.Y. 1906, c. 125). The United States District Court granted a temporary restraint against its enforcement and permitted collection of higher rates, requiring the excess to be impounded. Subsequently, in November, 1920 [(D. C.) 269 F. 452], an interlocutory order was entered finding the act confiscatory and permitting the impounded moneys to be withdrawn and future collections to be withheld from impounding upon substituting a bond or securities. A final decree in favor of the respondent was entered in May, 1921, and affirmed

by the Supreme Court in March, 1922. *Newton* v. *Brooklyn Union Gas Co.*, 258 U.S. 604, 42 S. Ct. 313, 66 L. Ed. 785. A final decree in favor of one of the subsidiaries, Newton Gas Company, was entered in October, 1921, and the appeal therefrom was dismissed by consent in 1923. 263 U.S. 726, 44 S. Ct. 4, 68 L. Ed. 527. Final decrees in favor of the other subsidiaries were entered in September, 1922, and not appealed. Prior to 1922 and pursuant to court decrees, either interlocutory or final, all moneys in excess of the statutory rate were either withheld or withdrawn from impoundment upon the giving of bonds, with the exception of some $673,000, which was withdrawn in 1922 after the litigation had ended. The Commissioner seeks to tax as 1922 income all moneys in excess of the statutory rate collected during 1920 and 1921.

The question presented is whether the excess moneys represented income to the respondent and its subsidiaries, reporting on the accrual basis, in the year when the rate litigation was finally terminated, as the Commissioner contends, on the ground that until then the right to such moneys was contingent. Rejecting this theory, the Board of Tax Appeals held that the excess moneys constituted income in the years when earned; that is, the years when the gas was furnished and the charges therefor were made against the consumers upon the companies' books. This resulted in allocating to income of years prior to 1922 some $8,600,000, thereby diminishing the tax deficiency which the Commissioner had determined for 1922. The appeal challenges this decision.

Were it not for the case of *North American Oil Consol.* v. *Burnet*, 286 U.S. 417, 52 S. Ct. 613, 76 L. Ed. 1197, we should unhesitatingly adopt the theory of the Board that the moneys in dispute were income in the year when the service was rendered. To that year was allocated the entire cost of manufacture and distribution of the gas, and to the same year should be attributed the whole price at which it was sold, if the taxpayer's profit on the transaction is to be accurately reflected by the accrual method of bookkeeping. The cases relating to compensation subsequently awarded to railroads for the years of federal control, upon which the Board relied, furnish a persuasive analogy. See *Commissioner* v. *Old Dominion S. S. Co.*, 47 F.(2d) 148 (C. C. A. 2); *Continental Tie & L. Co.* v. *United States*, 286 U.S. 290, 52 S. Ct. 529, 76 L. Ed. 1111; compare *Uncasville Mfg. Co.* v. *Commissioner*, 55 F.(2d) 893 (C. C. A. 2), cert. denied, 286 U.S. 545, 52 S. Ct. 497, 76 L. Ed. 1282. But the *North American Oil* Case gives us pause. There a receiver was appointed to operate certain property pending the outcome of a suit brought to contest the taxpayer's title thereto. Net income produced from the receiver's operation of the property in 1916 was turned over to the taxpayer in 1917, upon the entry of a final decree dismissing the bill of complaint. The decree was appealed, and the litigation was not terminated until 1922. The taxpayer contended that the net profit should be allocated either to 1916 or 1922, but the court held it to be income for the year 1917, when it was received. While this case casts doubt upon the correctness of the Board's theory that the excess moneys are to be allocated to the years, respectively, when the gas was sold, it strongly supports the decision that final termination of the litigation was not the critical moment. As the Supreme Court said, at page 424 of 286 U.S., 52 S. Ct. 613, 615, 76 L. Ed. 1197:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though

it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent

We think this is conclusive against the Commissioner's contention with respect to the excess moneys which prior to 1922 were withheld or withdrawn from impoundment upon bonds fixed by the court. Such money was income, being payment for service already rendered, and was received by the companies without restriction upon its use. It is true they were subject to a contingent liability to pay back an equivalent amount if the rate litigation ultimately went against them. This liability, however, imposed no restriction upon their use of the money actually in their hands. Nor did the fact that they gave bonds to get it add anything to the contingent liability they were under regardless of such bonds. Termination of the rate litigation merely determined their right to retain income already received. See *Board* v. *Commissioner*, 51 F.(2d) 73, 76 (C. C. A. 6). The money received prior thereto cannot be taxed as income of the year 1922.

This disposes of all the moneys involved in *Rate Case No. 1* and of all the moneys involved in *Rate Case No. 2*, except the $673,000 which was withdrawn from impoundment in 1922. This sum represented charges in excess of the statutory rate for gas furnished in 1920 or 1921. As to this the *North American Oil* decision tends to support the Commissioner's contention that the money was income in the year when received. However, two differences in the facts are to be noted. First, the *North American Oil* Case involved only net income resulting from the receiver's operations. The taxpayer there was not required to charge the receiver's expenses to 1916 while crediting his receipts to 1917. Hence there was no such distortion of the taxpayer's income as would result from applying the same rule to the case at bar. Here the entire cost of furnishing gas was charged to the year when the service was rendered, but on the Commissioner's theory only a part of the price charged to and collected from the consumer would be credited as income to that year; the remainder would be credited to income in 1922 and without carrying into that year any part of the expense of earning such income. Obviously this would produce an unfair distortion of the taxpayer's actual profits in each of the years. Secondly, in the *North American Oil* Case no court order was entered in 1916 finding that the taxpayer was entitled to funds in the receiver's hands. As the Supreme Court pointed out (286 U.S. at page 423, 52 S. Ct. 613, 76 L. Ed. 1197), there was no constructive receipt of the profits by the taxpayer in 1916, because at no time during that year had it a right to demand that the receiver pay over the money. In the case at bar, however, it was decided in November, 1920, that the statutory rate was confiscatory, and the respondent and its subsidiaries were declared to have a right to receive the impounded income without restriction, provided they filed bonds as security for their conditional liability to return a like sum. Their conditional right to get the impounded money could be turned into an absolute right at their own option. We do not think a taxpayer could alter at will the accrual of income by failing to exercise an option to receive it. A majority of the court believe that these differences in the facts are sufficient to distinguish the *North American Oil* Case, and that the order appealed from should be affirmed in toto. It is so ordered.

L. HAND, Circuit Judge (*dissenting* in part).

Even when the taxpayer has received the money, it is theoretically possible to

treat the item as in suspense, until the right to it has been determined, or as an immediate receipt, with a corresponding deduction, if it is later repaid. But the second was authoritatively laid down in *North American Oil Consol.* v. *Burnet*, 286 U.S. 147, 52 S. Ct. 613, 76 L. Ed. 1197, as applicable to accounts kept either on an accrual, or a cash, basis. This answers the main issue, and my only difference with my brothers is as to that part of the moneys impounded in Rate Cases No. 2, which was never withdrawn until the suits were determined. If the right to withdraw had been unconditional, perhaps we ought to treat this as though it were already in the coffers of the companies; it was equally available. Indeed, even if the companies had been required to give their individual bonds, these would in substance subject them to no other liability than they were under anyway. But the interlocutory decrees which allowed the withdrawal of $673,000, required them to deposit securities of their own, or the bonds of a surety company. It can scarcely be said that this made the moneys immediately available, like cash on deposit. The condition required them either to turn over equivalent property to the court, or to assume an obligation to the surety, which often demands security. I do not see how such moneys are any more received by the taxpayers, than if the court continued to impound them.

It is sometimes possible, when accounts are kept on an accrual basis, to ignore the conditional character of the right, but that is just what, as I read it, was denied in *North American Oil Consol.* v. *Burnet*, in a closely similar situation; the right unaccompanied by possession or its equivalent was too contingent. I agree that in fact the uncertainties were no greater then than those determining the recovery in the *Federal Control Cases.** But the distinction between the liquidation of a determined right, and the determination of a disputed right, is familiar throughout the law, though for practical purposes one may be as incalculable as the other. It is reasonable to import this distinction, taken in so many other situations. The "title" to the moneys was in genuine dispute; indeed the company's last efforts had been unsuccessful. To treat the impounded sums as presently accruable appears to me, therefore, to ignore a well recognized classification. As to $673,000 of the moneys in the *Rate Cases No. 2*, I therefore dissent; otherwise I concur.

Note

See *Globe Corp.* v. *Commissioner*, 20 T.C. 299 (1953), involving the accrual of about $181,000 owed to the taxpayer by the United States under certain contracts for the manufacture of equipment. The contracts provided that in the event the specifications were changed by the United States, the contract prices would be adjusted on a fair and equitable basis by negotiations between the parties. The government ordered changes, in a way that would increase the cost, on certain work that was completed in 1945. The price adjustments were in the process of negotiation during that year; in 1946, an agreement was reached by which the contract prices were increased by about $181,000. The Tax Court upheld the taxpayer's refusal to accrue the additional amount until 1946:

* These cases, some of which are cited in the majority opinion, involved payments under the Transportation Act of 1920, which contained provisions to compensate railroads for losses resulting from government control during World War I. In Continental Tie & Lumber Co. v. United States, 286 U.S 290 (1932), it was held that a railroad should have accrued in 1920 the amount due to it under the Act, although payment was not made until 1923, because the right to the payment was fixed when the Act took effect in 1920 and data then in the taxpayer's books would have enabled it to compute the amount which it was entitled to receive. [Ed.]

> Until a definite amount was arrived at under the negotiations provided for in the contracts involved herein petitioner had only a claim on a *quantum meruit* basis for goods and services rendered which, while of value, was too uncertain in amount to accrue.

The court relied in part on *Henry Hess Co.* v. *Commissioner*, 16 T.C. 1363, where it had held that the taxpayer was not required to accrue a claim for just compensation arising from the requisition of property by the government until the amount due was fixed by judicial proceedings or otherwise:

> It is not enough to state that the Fifth Amendment to the Federal Constitution guarantees just compensation and thereby fixes taxpayer's right. To this it might, with equal assurance, be rejoined that under our system of jurisprudence and the law as adjudicated by all American courts, every litigant is guaranteed ultimate justice or "equal justice under law." These principles are basic in our system of government. So to state, however, does not devitalize the considerations leading to the holding in innumerable cases that before an amount can be accrued, not only must the right to receive the amount be fixed, but the amount must be reasonably ascertainable. (16 T.C. at 1373–74.)

DIXIE PINE PRODUCTS CO. v. COMMISSIONER

Supreme Court of the U S., 1944
320 U.S. 516

Mr. Justice Roberts delivered the opinion of the Court.

The question presented concerns the propriety of the respondent's disallowance of a deduction from income which petitioner took in its federal income tax return for 1937.

In 1936 the Mississippi taxing authorities declared that a solvent used by petitioner in its business was gasoline within the meaning of a state law defining gasoline and laying a tax upon its receipt and use. Accordingly a tax was assessed against the petitioner with respect to the receipt and use of the solvent in 1936. Petitioner paid the tax, and, in the same year, brought suit against the Motor Vehicle Commissioner of Mississippi alleging that the solvent was not within the comprehension of the state law and that the Commissioner should be temporarily and permanently enjoined from future collections of tax in respect of it. The Commissioner's demurrer to the complaint was sustained but, on appeal, the Supreme Court of Mississippi decided that, on the pleadings, the solvent was not within the definition of gasoline contained in the state statute. After this decision petitioner denied that it owed, and ceased and refused to pay, any gasoline tax on solvent used by it.

In December, 1937, on advice of counsel, petitioner (which kept its books and filed its federal income tax returns on the accrual basis) made book entries accruing gasoline tax assessed by the Motor Vehicle Commissioner in 1937. The actual accrual entries were made sometime between January 1 and March 15, 1938, as of December 31, 1937, in the amount of approximately $21,000, and petitioner deducted this amount from income in making its 1937 federal income tax return, although the sum had not been, and never was, paid.

In December 1938 petitioner and the Attorney General of Mississippi filed an agreed statement of facts in the state court suit, and, in the same month, the trial judge entered a final decree perpetually enjoining the Motor Vehicle Commissioner from assessing gasoline tax on the solvent used by petitioner. This decree

was subsequently affirmed by the Supreme Court of Mississippi. In its 1938 federal income tax return petitioner, by way of compensating entry, included the sum of $21,000 as income and as a recovery, in view of the Mississippi trial court's decree of December 1938.

The sole question is whether the Commissioner was right in disallowing the deduction for the tax year 1937. The Board of Tax Appeals held that he was, and the court below affirmed its decision. We took the case because of a conceded conflict in principle with decisions in other circuits.

Section 23(c) [§ 164 of the 1954 Code] permits the deduction from gross income of taxes "paid or accrued within the taxable year." Sections 41, 42, and 43 make provision for tax accounting on the accrual basis, where the taxpayer keeps his books on that principle, provided his method clearly reflects his income in any taxable year.

The provisions of the Revenue Act of 1936 worked no significant change over earlier Acts respecting the permissible basis of calculating annual taxable income. The applicable principles of accounting on the accrual basis had been adduced and applied by the Board of Tax Appeals in numerous decisions. It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax, on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated.

To this effect are the decisions of the Board of Tax Appeals in numerous cases, and the instant decision was in line with earlier rulings as to proper tax accounting practice. Since the Board applied the correct rule of law, its determination that the item in question was not properly deducted on the accrual basis is entitled to the finality indicated by *Dobson* v. *Helvering*, 320 U.S. 489, 64 S. Ct. 239. The court below properly refused to disturb the Board's determination.

Affirmed.

Note

1. Would the 1937 accrual have been justified if the taxpayer had brought no suit itself but had refused to pay pending advice of its attorney?

2. Security Flour Mills Co. v. *Commissioner*, 321 U.S. 281 (1944), involved a taxpayer who contested the constitutionality of the processing tax levied by the Agricultural Adjustment Act of 1933. The taxpayer brought suit to enjoin collection and the court ordered the amount of the tax to be paid into a depository *pendente lite*. In 1935 the taxpayer made deposits in the amount of about $93,000 and, in computing the prices to be charged its customers, it considered the tax as a cost of production. Some of the customers were advised, however, that the taxpayer would treat them "fairly" in the event the tax was held unconstitutional, although no enforceable obligations were assumed. In 1936 the tax was held unconstitutional and the court ordered the deposited

funds to be returned to the taxpayer, though only after claims to the same funds had been interposed by certain customers and rejected by the court. In the years 1936–38 the taxpayer refunded about $45,000 to certain of its customers, those whose goodwill it wished to cultivate. The taxpayer sought to deduct for the year 1935 the $45,000 paid out in 1936–38 on the theory that income would be distorted if the gross sales price of its product was reported in 1935 and the refunds were deducted in later years. (An effort was also made to obtain a deduction for the full amount of the taxes, but this was not the taxpayer's primary contention, and the *Dixie Products Co.* case, decided while its case was pending before the Supreme Court, disposed of this issue.) The taxpayer relied on a proviso of § 43 of the 1939 Code* that deductions and credits were to be taken in the year paid or accrued, depending on the taxpayer's method of accounting, "*unless* in order to clearly reflect the income the deductions or credits should be taken as of a different period." The Supreme Court rejected this argument, saying:

> In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust or unfair not to isolate the transaction and treat it on the basis of the long term result. We think the position is not maintanable.
>
> The Revenue Act of 1921, in Secs. 214(a)(6) and 234(a)(4) authorized the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, that was necessary clearly to reflect income. The qualifying clause of Sec. 43 was first added as Sec. 200(d) of the Revenue Act of 1924. The reports of both House and Senate Committees concerning this change said: "The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should." (39–1 C.B. (Part 2) 249.)
>
> From these reports it is clear that the purpose of inserting the qualifying clause was to take care of fixed liabilities payable in fixed installments over a series of years. For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year. But we think it was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer. (321 U.S. at 285–286.)

3. See Raum, "Current Developments on Accrual of Taxes," *12th Annual N.Y.U. Inst. on Fed. Taxation* 647 (1954).

BALTIMORE TRANSFER CO. v. COMMISSIONER

Tax Court of the U. S., 1947
8 T.C. 1

[In 1943 the taxpayer was notified by the Maryland Unemployment Compensation Board that its contribution to the state unemployment compensation fund should be computed on the basis of 2.7 percent of its total annual payroll.

* The corresponding provision of the 1954 Code, § 461(a), is worded somewhat differently, but, since § 446(b) provides that the method of accounting must "clearly reflect income," presumably no substantive change was intended.

The taxpayer, which was on the accrual basis, computed its liability accordingly, accrued the amount thus computed as a liability, and deducted it for the year 1943. The following year the Board decided that its advice to the taxpayer had been erroneous, in that the applicable rate was only 0.9 percent, and refunded the excess by a credit to the taxpayer's account. The recomputation by the Board was based on advice of counsel to the effect that the employment experience of several enterprises under common control should be combined in computing the applicable contribution rate.

[The taxpayer deducted the full amount accrued in 1943 and reported the refund (which was credited to its account by the Board) as income in 1944. The Commissioner determined a deficiency on the ground that only the net amount was deductible for 1943.]

Hill, Judge: Respondent determined deficiencies in petitioner's income tax and excess profits tax liabilities for the calendar year 1943 in the respective amounts of $4,260.03 and $347.31. Only a portion of the deficiencies is in controversy. The sole question presented is whether petitioner is entitled to deduct an amount accrued by it in the taxable year as due to the Maryland Unemployment Compensation Fund, which amount was subsequently paid but was refunded to petitioner in 1944. . . .

Many times we and the Circuit Court of Appeals have considered the general question which is presented here, that is, whether a taxpayer is entitled to deduct expenses or taxes paid or accrued in the taxable year, but later refunded, or liability for which is canceled. It once seemed that *E. B. Elliott Co.*, 45 B.T.A. 82, established the most comprehensive rule for the solution of this vexatious problem and marked our attainment of a definite position with respect thereto. Subsequently, however, the Supreme Court, in deciding an allied question in *Security Flour Mills* v. *Commissioner*, 321 U.S. 281, laid down general principles which conflict with our remarks in the *Elliott* case. In its opinion the Supreme Court quoted from *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, as follows:

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.
>
> . . . It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

and went on to say:

> This legal principle has often been stated and applied. The uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.

We think the application of these principles disposes of this proceeding in favor of the petitioner. In our view, its obligation to pay the full amount deducted was sufficiently certain at the close of the taxable year to justify its accrual, whereas the right to receive the refund credit became final, if at all, in the following year.

The Maryland Unemployment Compensation Board, pursuant to its delegated authority as a collecting agency of the state government, notified petitioner in July 1943 that for the current fiscal year it would owe 2.7 per cent of the wages paid to its employees. Petitioner accordingly accrued its quarterly liability at that rate. The amounts accrued were paid, apparently, shortly after the close of each quarterly accounting period. The total amount here involved was paid prior to the filing of petitioner's Federal tax returns for the calendar year 1943. Petitioner deducted these amounts on those returns.

It is apparent from the stipulated facts that petitioner neither denied nor questioned its liability for any portion of the accrued sums and had no reason prior to April 21, 1944, even to suspect that it might subsequently receive or be entitled to receive a refund or credit thereof. The Board was legislatively authorized to determine the contribution rate for each employer and petitioner had filed with it all the facts and information pertinent to that determination. Neither prior to nor at any time after the receipt of the July rate notification was there any question of the constitutionality of the controlling statute, its application to petitioner, or its imposition of an obligation upon it. It therefore seems reasonable and not at all surprising that all the indications are that petitioner accepted the administrative determination as correct and acted accordingly until April 1944, when it was notified that for rate purposes its account had been combined with that of its affiliates. The propriety of the accruals must be judged by the facts which petitioner knew or could reasonably be expected to know at the closing of its books for the taxable year, and under the circumstances here we think that the accruals must be regarded as proper. *Cf. Chestnut Securities Co.* v. *United States*, 62 Fed. Supp. 574; *Stanard-Tilton Milling Co.*, 3 T.C. 1026, 1029.

Contending otherwise, respondent says that petitioner's correct liability was ascertainable on December 31, 1943, since the Maryland statute was then in effect and all the operative facts were known. He urges that section 39.43—2 of Regulations 118 requires taxpayers to make every reasonable effort to ascertain the facts necessary to make a correct return and he argues that here "any inquiry or verification of its actual liability" would have revealed to petitioner the true amount of the obligations.

Though respondent's premise may be correct conceptually, we think his conclusion does not follow. In the first place, the argument ignores the practical compulsion and prima facie validity which we believe the business man may properly attribute to an administrative notification such as that first received by petitioner. It seems obvious to us that a proper accrual of such an obligation so asserted and which the taxpayer sees no reason to challenge is not conditioned upon his testing it judicially or by professional legal opinion. In this connection petitioner's position is quite different from that of the taxpayer in *Cooperstown Corporation* v. *Commissioner*, 144 Fed.(2d) 693, which voluntarily assessed itself with liability under a statute which for factual reasons peculiarly within its own knowledge did not impose upon it any liability whatsoever. Such a unilateral and possibly selfserving determination may conceivably be regarded as establishing only a liability contingent upon some indication of concurrence by the collecting authority, but obviously no similar degree of uncertainty can fairly be said to taint the accruals involved here.

There is a further reason why we can not approve the above stated argument

of respondent. His theory seems to be that, where there is no change in pertinent law or facts after the end of the taxable year, the true liability and that only is accruable because as a matter of law it is *ascertainable.* This is logically equivalent to saying that if doubt as to correct liability hinges solely upon a question of law, the accrual must be made within the taxable year according to the ultimate resolution of that question, since the determination awaited only a pronouncement by a legal expert. Such a theoretical and totally unrealistic approach can not survive the application of the rationale of the *Security Flour Mills* decision and *Dixie Pine Products Co.* v. *Commissioner,* 320 U.S. 516, in each of which the Supreme Court clearly indicated that a controverted obligation is not accruable until the dispute is settled, even though the question is purely one of law. The disallowances of the deductions in those cases were not based on the fact that it was ultimately concluded that as a matter of law each taxpayer had no obligation and thus there was nothing to accrue. The determinative question in each of those proceedings was, as it is here, whether the accrual was proper under sound accounting principles. . . .

Respondent also argues that it is now known that the accrual and deduction were erroneous to the extent of the refund and he contends, citing *Inland Products Co.* v. *Blair,* 31 Fed.(2d) 867, and other cases to similar effect, that he may correct the mistake retroactively by disallowing that portion of the deduction. We have stated above our conclusion that the accruals were proper on the basis of facts known at the close of the taxable year and it would seem to follow therefrom that as a matter of right petitioner is entitled to the deduction it took. . . .

The Supreme Court denied in the *Security Flour Mills* case that events occurring in a subsequent year may be seized upon as a basis for determining the allowable deductions of an earlier period. The aim of the taxing acts is to determine true income by annual periods, not true income "in the light of ultimate gain from a series of transactions over a period of years growing out of, or in some way related to an initial transaction in the taxable year." We accordingly believe that, in so far as the *Inland Products Co.* case approves the disallowance of deductions so as to reflect *ultimate* expenditure for a particular purpose rather than expenditure *of the taxable year,* it, like *E. B. Elliott Co., supra,* is of no standing today as authority.

Note

See *Keller-Dorian Corp.* v. *Commissioner,* 153 F.2d 1006 (2d Cir. 1946), involving a taxpayer who imported certain goods in the years 1936–40 and paid customs duties to the United States on the basis of values approved by the customs authorities. Subsequently the goods were reappraised and additional amounts were paid as duties in 1941 and 1942 as a result of the reappraisals. The court held that the additional payments could not be deducted in 1941 and 1942. (Apparently the earlier years were closed by the statute of limitations). It said:

> The Tax Court ruled that customs duties are taxes and must be treated for income tax purposes in the same manner as any other taxes; that since the petitioner reported on the accrual basis, it was obliged to accrue the duties in the taxable year in which the merchandise was imported, if all the facts had occurred in that year to fix the amount and the fact of the taxpayer's liability; and that the record did not show that such facts had not then occurred. We see no escape from this conclusion. The liability of an importer for customs duties accrues when the goods arrive at the port of entry. . . . The petitioner failed to show that the reappraisals which

resulted in the additional customs duties were not required to correct errors in the original computations. This court has held that if the correct amount of a tax is ascertainable in the year when the liability accrues, even though it was not in fact then ascertained, the later correction of the error in computation does not entitle the taxpayer (on accrual basis) to take a deduction in the year when the additional tax is paid. *Uncasville Mfg. Co.* v. *Commissioner*, 2 Cir., 55 F.2d 893, 895, certiorari denied 286 U.S. 545, 52 S. Ct. 497, 76 L. Ed. 1282. . . . This principle appears to us conclusive of the case at bar. Since the record does not show why reappraisals were required in 1940 and 1941 we must assume that the customs officials acted lawfully in requiring them; that means, since there was no change in the statute, that a basis of computation was originally applied which the officials later discovered to have been erroneous. The *Uncasville* case establishes that such a legal error cannot be used by a taxpayer as a basis for saying that he could not have known the correct amount of the taxes (or customs duties) in the earlier years when they accrued. (153 F.2d at 1007.)

2. *The Use of Hindsight*

BURNET v. SANFORD & BROOKS CO.

Supreme Court of the U. S., 1931
282 U.S. 359

Mr. Justice Stone delivered the opinion of the Court.

In this case certiorari was granted to review a judgment of the Court of Appeals for the Fourth Circuit, 35 F.(2d) 312, reversing an order of the Board of Tax Appeals, 11 B.T.A. 452, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

From 1913 to 1915, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the payments received by $176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915 work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of warranty of the character of the material to be dredged. Judgment for the claimant, 53 Ct.Cl. 490, was affirmed by this Court in 1920. *United States* v. *Atlantic Dredging Co.*, 253 U. S. 1, 40 S. Ct. 423, 425, 64 L. Ed. 735. It held that the recovery was upon the contract and was "compensatory of the cost of the work, of which the government got the benefit." From the total recovery, petitioner received in that year the sum of $192,577.59, which included the $176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to $16,305.71. Respondent having failed to include these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

The Court of Appeals ruled that only the item of interest was properly in-

cluded, holding, erroneously as the government contends, that the item of $176,-271.88 was a return of losses suffered by respondent in earlier years and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years. Respondent insists that as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent's contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, see *Eisner* v. *Macomber*, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521, 9 A.L.R. 1570, *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179, 38 S. Ct. 467, 62 L. Ed. 1054, the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under sections 230, 232 and 234 (a) of the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. By sections 233 (a) and 213 (a) gross

> income includes . . . income derived from . . . business . . . or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under Section 212 (b). See *United States* v. *Anderson*, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347; *Aluminum Castings Co.* v. *Routzahn*, 282 U.S. 92, 51 S. Ct. 11.

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See *Doyle* v. *Mitchell Brothers Co.*, *supra*, page 185 of 247 U.S., 38 S. Ct. 467.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of Section 213 (a) and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

Bowers v. *Kerbaugh-Empire Co.*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886, on which respondent relies, does not support its position. In that case the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

But respondent insists that if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. See *Bowers* v. *Kerbaugh-Empire Co.*, *supra*, page 174 of 271 U.S., 46 S. Ct. 449; *Pacific Insurance Co.* v. *Soule*, 7 Wall, 433, 19 L. Ed. 95; *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601, 630, 15 S. Ct. 912, 39 L. Ed. 1108. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular trans-

actions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another.

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. One was by returns on the accrual basis under Section 212(b), which provides that a taxpayer keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect its income, may, subject to regulations of the Commissioner, make its return upon the basis upon which its books are kept. See *United States* v. *Anderson*, and *Aluminum Castings Co.* v. *Routzahn*, *supra.* The other was under Treasury Regulations (article 121 of Reg. 33 of Jan. 2, 1918, under the Revenue Acts of 1916 and 1917; article 36 of Reg. 45, April 19, 1919, under the Revenue Act of 1918) providing that in reporting the income derived from certain long term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed, or report in each year the percentage of the estimated profit corresponding to the percentage of the total estimated expenditures which was made in that year.*

The Court of Appeals said that the case of the respondent here fell within the spirit of these regulations. But the court did not hold, nor does respondent assert, that it ever filed returns in compliance either with these regulations, or Section 212 (b), or otherwise attempted to avail itself of their provisions; nor on this record do any facts appear tending to support the burden, resting on the taxpayer, of establishing that the Commissioner erred in failing to apply them. See *Niles Bement Pond Co.* v. *United States*, 281 U.S. 357, 361, 50 S. Ct. 251, 74 L. Ed. 901.

The assessment was properly made under the statutes. Relief from their alleged burdensome operation which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

Note

1. Statutory provision for the carry-over of losses appeared for the first time in the Revenue Act of 1918, and only losses occurring subsequent to its enactment qualified. Would the taxpayer have been materially aided if § 172 of the present Code had been in effect for the years in question?

2. Note the Court's statement: "The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment." Could Congress require income to be computed on a monthly or weekly basis and deny any carry-over of losses between such periods?

3. *Bowers* v. *Kerbaugh-Empire Co.*, distinguished by the Court, involved this situation: The taxpayer borrowed funds from a German bank prior to World War I. The lender transmitted marks to its New York representative, who converted the marks into dollars and advanced the dollars to the taxpayer. The taxpayer agreed to repay the loan in marks or in their equivalent in gold coin of the United States. As of March 31, 1915, the balance due was 3,216,445 marks. In 1921, the taxpayer paid off the balance

* *Supra*, p. 707. [Ed.]

(to the Alien Property Custodian, the successor in title to the lender) with dollars at the then rate of exchange, 2½ cents per mark, an amount far less than the value of the marks when borrowed. The difference between the dollars received by the taxpayer under the loan and the amount paid to discharge it was about $685,000. The borrowed funds had been lost by the taxpayer in the years 1913–18. The court held that the difference between the dollars received by the taxpayer and the amount paid in 1921 was not income:

> The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. The essential facts set forth in the complaint are the loans in 1911, 1912, and 1913, the loss in 1913 to 1918 of the moneys borrowed, the excess of such losses over income by more than the item here in controversy, and payment in the equivalent of marks greatly depreciated in value. The result of the whole transaction was a loss. . . . When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value, but the mere diminution of loss is not gain, profit, or income. (271 U.S. at 175.)

Does the *Sanford & Brooks Co.* case distinguish the *Kerbough-Empire Co.* case on the ground that the repayment of a loan for less than face value cannot produce income? In *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), summarized in the *Dallas Transfer & Terminal Warehouse Co.* case, *supra*, p. 69, the Supreme Court said of the *Kerbough-Empire Co.* case:

> At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. (284 U.S. at 3)

See Magill, *Taxable Income* (rev. ed. 1945), pp. 245–254

HEALY v. COMMISSIONER

Supreme Court of the U. S , 1953
345 U.S. 278

Mr. Chief Justice VINSON delivered the opinion of the Court.

The income tax liability of three individual taxpayers for a given year is here before the Court. Only a single question, common to all the cases, is involved. The Tax Court held a view favorable to the taxpayers. The Commissioner of Internal Revenue sought review before the appropriate Courts of Appeals. As to two of the taxpayers, the Court of Appeals for the Second Circuit reversed, while the Court of Appeals for the Sixth Circuit took a contrary view of the law. We granted certiorari to resolve the conflict.

All controlling facts in the three situations are similar. Each taxpayer reports his income on the cash receipts and disbursements method. Each, in the respective years involved, received a salary from a closely held corporation in which he was both an officer and a stockholder. The full amount of salary so received was reported as income for the year received. Subsequently, after audit of the corporate returns, the Commissioner disallowed the deduction by the corporations of parts of the salaries as exceeding reasonable compensation. As a result, deficiencies in income taxes were determined against the corporations. The Commissioner also determined that the officers were liable as transferees under § 311 [§ 6901(a)(1) of

the 1954 Code], for the corporate deficiencies.* The receipt of excessive salary was the transfer upon which the transferee liability was predicated. As a result of either litigation or negotiation, various amounts became established as deficiencies of the corporations and as transferee liabilities of each of the three officers. In each case, the entire process of determining these amounts—from the start of the audit by agents of the Commissioner to the final establishment of the liabilities—occurred after the end of the year in which the salary was received and reported.

The question before the Court is whether part of the salary should be excluded from taxable income in the year of receipt since part was excessive salary and led to transferee liability for the unpaid taxes of the corporations. The taxpayers contend that an adjustment should be made in the year of original receipt of the salary; the Government that an adjustment should be made in the year of payment of the transferee liability.

One of the basic aspects of the federal income tax is that there be an annual accounting of income. Each item of income must be reported in the year in which it is properly reportable and in no other. For a cash basis taxpayer, as these three are, the correct year is the year in which received.

Not infrequently, an adverse claimant will contest the right of the recipient to retain money or property, either in the year of receipt or subsequently. In *North American Oil Consolidated* v. *Burnet*, 1932, 286 U.S. 417, 52 S. Ct. 613, 76 L. Ed. 1197, we considered whether such uncertainty would result in an amount otherwise includible in income being deferred as reportable income beyond the annual period in which received. That decision established the claim of right doctrine "now deeply rooted in the federal tax system." [1] The usual statement of the rule is that by Mr. Justice Brandeis in the North American Oil opinion:

> If a taxpayer receives earnings under a claim of right and without restrictions as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. (286 U.S. at page 424, 52 S. Ct. at page 615.)

The phrase "claim of right" is a term known of old to lawyers. Its typical use has been in real property law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession as owner. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist. A mistaken claim is nonetheless a claim, *United States* v. *Lewis*, 1951, 340 U.S. 590, 71 S. Ct. 522, 95 L. Ed. 560.

However, we are told that the salaries were not received as belonging to the taxpayers, but rather they were received by the taxpayers as "constructive trustees" for the benefit of the creditors of the corporation. Admittedly, receipts by a trustee expressly for the benefit of another are not income to the trustee in his individual capacity, for he "has received nothing . . . for his separate use and benefit," *Eisner* v. *Macomber*, 1920, 252 U.S. 189, 211, 40 S. Ct. 189, 194, 64 L. Ed. 521.

We do not believe that these taxpayers were trustees in the sense that the

* On transferee liability, see *infra*, p. 834. [Ed.]

[1] United States v. Lewis, 1951, 340 U.S. 590, 592, 71 S. Ct. 522, 523, 95 L. Ed. 560.

salaries were not received for their separate use and benefit. Under the equitable doctrine that the funds of a corporation are a trust fund for the benefit of creditors, a stockholder receiving funds without adequate consideration from an insolvent corporation may be held, in some jurisdictions, to hold the funds as a constructive trustee. So it was that these taxpayers were declared constructive trustees and were liable as transferees in equity. A constructive trust is a fiction imposed as an equitable device for achieving justice. It lacks the attributes of a true trust, and is not based on any intention of the parties. Even though it has a retroactive existence in legal fiction, fiction cannot change the "readily realizable economic value" [2] and practical "use and benefit" [3] which these taxpayers enjoyed during a prior annual accounting period, antecedent to the declaration of the constructive trust.

We think it clear that the salaries were received under a claim of individual right—not under a claim of right as a trustee. Indeed one of the parties concedes, as is manifestly so, that the reporting of the salary on the income tax returns indicated that the income was held under a claim of individual right. The taxpayers argue that the salary was subject to a restriction on its use.[4] Since all the facts which ultimately gave rise to the transferee liability were in existence at the end of the taxable year, we are told those facts were a legal restriction on the use of the salary. Actually it could not have been said at the end of each of the years involved that the transferee liability would materialize. The Commissioner might not have audited one or all of these particular returns; the Commissioner might not have gone through the correct procedure or have produced enough admissible evidence to meet his burden of proving transferee liability, [5] or, through subsequent profitable operations, the corporations might have been able to have paid their taxes obviating the necessity of resort to the transferees.[6]

There is no need to attempt to list hypothetical situations not before us which put such restrictions on use as to prevent the receipt under claim of right from giving rise to taxable income. But a potential or dormant restriction, such as here involved, which depends upon the future application of rules of law to present facts, is not a "restriction on use" within the meaning of *North American Oil* v. *Burnet*, *supra.*

The inequities of treating an amount as income which eventually turns out not to be income are urged upon us. The Government concedes that each of these taxpayers is entitled to a deduction for a loss in the year of repayment of the amount earlier included in income. In some cases, this treatment will benefit the taxpayer; in others it will not. Factors such as the tax rates in the years involved and the brackets in which the income of the taxpayer falls will be controlling. A rule which required that the adjustment be made in the earlier year of receipt

[2] Rutkin v. United States, 1952, 343 U.S. 130, 137, 72 S Ct 571, 575, 96 L. Ed 833.

[3] Eisner v. Macomber, 1920, 252 U.S. 189, 211, 40 S. Ct. 189, 194, 64 L. Ed. 521.

[4] The rule announced in North American Oil v. Burnet, *supra,* requires a receipt without "restriction on use" as well as under a claim of right

[5] I.R.C. § 1119 imposes upon the Commissioner the burden of proving transferee liability. This may be contrasted to the rule that normally the burden of proof is on the taxpayer contesting the determination of the Commissioner. I.R.C. § 1111, Rule 32, Tax Court of United States. [§§ 6902(a) and 7453 of the 1954 Code.]

[6] Transferee liability is secondary to the primary liability of the transferor. To sustain transferee liability the Commissioner must prove that he is unable to collect the deficiency from the transferor. 9 Mertens, *Law of Federal Income Taxation*, § 53.29.

instead of the later year of repayment would generally be unfavorable to taxpayers, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year. Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the counting must be done over again to reflect events occurring after the year for which the count is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed.

The judgment of the Court of Appeals for the Second Circuit in No. 76, being consistent with this opinion, is affirmed, while the contrary judgment of the Court of Appeals for the Sixth Circuit in No. 138 is reversed. It is so ordered.

Judgment in No. 76 *affirmed*; judgment in No. 138 *reversed.*

Mr. Justice DOUGLAS *dissents.*

Note

1. See also *United States* v. *Lewis, supra,* p. 92. In *United States* v. *Lesoine,* 203 F.2d 123 (9th Cir. 1953), it was held that stockholders were liable for a tax on dividends received in the year 1942, although they repaid the dividends to the corporation in the following year, upon discovery that surplus had been insufficient for the payment of dividends. *Knight Newspapers, Inc.* v. *Commissioner,* 143 F.2d 1007 (6th Cir. 1944), which was contrary, was not followed in the *Lesoine* case: it rested on the "constructive trust" theory rejected by the Supreme Court in the *Healy* case.

2. What is the statutory authorization for deducting the repayment as a "loss"? If reporting the salary in the year of the receipt had produced no tax (because the taxpayer had an over-supply of deductions), would he have had a loss in the year of repayment? See *O'Meara* v. *Commissioner,* 8 T.C. 622 (1947). See also Regs. 118, Sec. 39.23(k)-2, providing that claims (as for salary, rent, etc.) may be deducted as bad debts only if they have been "included in the return of income" for the taxable, or some previous, year. There is apparently no requirement that the inclusion in the return produce a tax.

3. As pointed out *supra,* p. 727, § 1341 of the 1954 Code provides that if the deduction exceeds $3,000, the tax benefit from the deduction shall not be less than the tax attributable to the item's inclusion in income in the earlier year. But there is no converse requirement that the value of the deduction may not *exceed* the tax cost of including the item. Perhaps the government will be less enthusiastic about the claim of right doctrine in the future.

FORT PITT BREWING CO. v. COMMISSIONER

U. S. Court of Appeals, Third Circuit, 1954
210 F.2d 6, cert. den. 347 U. S. 989

Before GOODRICH, STALEY and HASTIE, Circuit Judges.

By HASTIE, Circuit Judge:

We are asked to decide whether, in the particular circumstances of this case, Section 41 of the Internal Revenue Code justified the Commissioner of Internal Revenue in making "adjustments" of the Fort Pitt Brewing Company's gross income for 1942 and 1943, adding to income the amount of the net increase during each taxable year of the taxpayer's accounting "Reserve for Returnable Containers."

Section 41 [see § 446(b) of the 1954 Code] provides that

if the method [of accounting] employed [by a taxpayer] does not clearly reflect the

income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

Also in force at the times in question and implementing Section 41 was Section 39.41-1 of Treasury Regulation 118 which required that "The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such manner as clearly reflects the taxpayer's income." The Regulation provided further that where this is not accomplished by taxpayer's regular method of accounting, "the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects ... [income]."

Taxpayer, a Pennsylvania corporation, produces and sells large quantities of malt and brewed beverages. It maintains its accounts on the accrual basis. It provides returnable containers—bottles, kegs and barrels—in which it packages and distributes its products. A regulation of the Pennsylvania Liquor Control Board requires a stipulated minimum deposit on all returnable original containers of gallon size or less in which brewed beverages are sold. All of the taxpayer's invoices contain the following stipulation:

Deposit for return of package is as follows. Barrels $8.00, Half Barrels $6.00, Quarter Barrels $4.00 and Eighth Barrels $1.00 each, Cartons of 2 Dozen Small Bottles 50¢, Case of 2 Dozen Small Bottles 75¢, Bottles short in cases returned will be charged at rate of 2¢ for small bottles. Purchaser buys only the beer delivered and billed. Bottles, Cases, Kegs, Etc. containing the products delivered therein are never sold but remain absolute property of Brewing Company. Deposit for return of packages repaid purchaser for number delivered only on return of packages to Brewing Company. Purchaser agrees to these conditions.

No time limit is specified for the return of containers. During 1942 taxpayer received deposits of almost $5,000,000 on containers. During 1943 the figure approached $6,000,000. Refunds in 1942 were nearly $100,000 less than deposits, and in 1943 over $200,000 less. A year by year picture of deposits, refunds and consequent bookkeeping accumulations is provided by the following table, with the taxable years italicized:

Fiscal Year Ended Oct. 31	Deposits Received	Deposits Refunded	Excess of Deposits Over Refunds	Balance in Reserve
1936 Balance				17,962.50
1937	842,464.25	832,179.75	10,284.50	28,247.00
1938	1,214,122.75	1,184,063.25	30,059.50	58,306.50
1939	2,381,485.50	2,335,750.65	45,734.85	104,041.35
1940	3,063,054.00	3,035,347.75	27,706.25	131,747.60
1941	3,998,938.27	3,910,821.23	88,117.04	219,864.64
1942	*4,822,919.50*	*4,739,947.90*	*82,971.60*	*302,836.24*
1943	*5,940,221.75*	*5,759,025.50*	*181,196.25*	*484,032.49*
1944	7,587,196.25	7,457,638.00	129,558.25	613,590.74
1945	7,500,625.50	7,400,878.25	99,747.25	713,337.99
1946	8,176,090.50	8,034,014.00	142,076.50	855,414.49
1947	9,824,681.00	9,601,216.32	223,464.68	1,078,879.17
1948	12,225,591.00	12,144,419.25	81,171.75	1,160,050.92
1949	12,260,618.50	12,364,799.00	(104,180.50)	1,055,870.42
1950	10,112,643.00	10,090,142.75	22,500.25	1,078,370.67
1951	8,401,717.25	8,455,950.25	(54,233.00)	1,024,137.67

The foregoing table is a summary of data carried in taxpayer's books as a "liability account" under the title "Reserve for Returnable Containers." At no time have any of these transactions or their economic consequencies been permitted to enter into taxpayer's computation of its gross income. Yet, at no time did taxpayer in any way segregate money thus deposited from ordinary income or restrict its use in the ordinary course of its business.

In argument taxpayer has sought to picture this "Reserve" as something in the nature of a trust fund. But taxpayer itself never really regarded or dealt with these container deposits as a trust fund, or even as an actual reserve. As we already have said, taxpayer mingled such receipts with its general funds using them indiscriminately in its business. No reserve fund for repayment of deposits was set aside at the end of the year, or at any other time. A "Reserve" existed on paper in the taxpayer's books of account, but in no other way. For purposes of comparison it seems worth noting that even the conventional bank deposit creates only a simple debt. Here the deposit for containers creates no more than a contractual obligation to repay the amount deposited, if and when the containers shall be returned.

But even though no trust is created, such a procedure of deposits and repayments is not designed for gain; yet, at times it may yield income. These characteristics are properly reflected in accounting and recognized in taxation. One familiar method of accounting for such transactions is based upon a conception of each cash deposit as security for the bailment of some article or articles, subject, however, to a mutual understanding that failure to return the property will result only in the discharge of the conditional obligation to repay the amount deposited. In this method of accounting, the distributed articles remain in the distributor's inventory, subject to depreciation, even though possession has been surrendered to someone else and return is uncertain. The amounts deposited are set up in a special account and regarded as wholly or partially offset by concomitant liability to make repayment. If this offset is only partial, the unobligated balance goes into current income. If the offset is total, no income is said to be realized at that time. It is at this point in accounting, the determination of the relationship between deposits and offsetting liability, that the difficulties in this case begin.

Where great numbers of articles are distributed in the course of trade to many persons, some will never be returned. Where the articles are destructible and in rather easily disposable containers it is obvious that a very considerable number will not be returned. It may be possible, largely on the basis of experience, to make a reasoned prediction of the percentage of the distributed articles which will not be returned. For this fraction of the deposits the theoretical offsetting repayment liability is not real. Accordingly, such offset will not be claimed when the fraction was determined in advance or at the end of each accounting period. Rather, the current account will show a minor fraction of the year's deposits with the offsetting liability, and this practically unobligated amount will be entered in the taxpayer's record of current income.

But in some situations it may not be feasible thus to approximate each year the percentage of current deposits which will never actually be required to meet repayment demands. So the taxpayer may elect to set up initially in its accounting for current deposits a theoretical 100 percent offsetting liability, with the result

that there is no immediate determination of income, although in any given accounting period deposits may substantially exceed repayments. But if this is to be a bona fide and acceptable method of accounting it must be attended or followed by some fair and reasonably prompt determination or plan for determining at what time and in what amount any bookkeeping accumulation of actual deposits in excess of actual repayments shall be deemed to exceed future requirements for repayment and thus necessitate a transfer of the excess to surplus with attendant recognition of that sum as income.

The taxpayer here consistently from year to year maintained its accounts on the basis of a 100 percent offset of current deposits by a theoretical liability to make repayment for all containers. Yet, year by year its books revealed an increasing accumulation of an actual excess of deposits over repayments. This situation did not lead the taxpayer to adopt or propose any reasonable basis or time for a bookkeeping transfer of excess accumulations to an income category. Instead, taxpayer took and still defends the position that it may accumulate on its books indefinitely and without any restriction the excess of deposits over repayments. Thus an accounting procedure which, properly used, might legitimately have resulted in some postponement of accounting for sums as income until the amount thereof could be ascertained in fair approximation, has been misused to withhold the reporting of income indefinitely at the uncontrolled will and convenience of the taxpayer.

The impropriety of this procedure and the distorted picture of taxpayer's income it creates are the more glaring because of another accounting procedure which has been followed at the same time. We have already stated that all of taxpayer's containers, including those which were in the possession of the trade, were at all times carried in taxpayer's inventory. Moreover, each year in its accounting for income tax purposes taxpayer has claimed depreciation deductions on the cost of all of its containers at annual rates varying from 20 percent on bottles to 5 percent on barrels. This process necessarily results in a few years in an accounting recovery of substantially the entire cost of every container. The cost of containers, reserve for depreciation and undepreciated cost as shown in taxpayer's books are as follows:

Fiscal Year Ended October 31	Total Cost	Reserve for Depreciation	Undepreciated Cost
1936	$ 70,231.47	7,023.15	.
1937	100,928.47	9,260.66	91,667.81
1938	163,010.04	25,142.80	137,867.24
1939	258,362.95	51,334.14	207,028.81
1940	361,933.66	89,886.08	272,047.58
1941	481,391.01	144,891.32	336,499.69
1942	576,729.35	200,540.89	376,188.46
1943	666,368.03	254,981.61	411,386.36

It will be noted that in the taxable years alone the claimed container depreciation amounted to more than $100,000. Certainly, as the Tax Court found, some significant part of this annual depreciation must have represented loss and breakage of containers distributed to the trade. Yet, when it came to offsetting container deposits and preventing any part thereof from entering an income category, tax-

payer claimed continuing full theoretical liability to pay for every container distributed since 1936. If a depreciation reserve for containers is maintained which recognizes and embraces some substantial loss and breakage of containers in the possession of the trade, certainly the so-called reserve for redemption of containers should be maintained, not at a theoretical maximum, but at a lesser figure similarly recognizing practical factors which reduce returns substantially below their theoretical maximum.

Here then is a clear and rather extreme case of accounting practice resulting in a substantial distortion of the picture of the taxpayer's income. The case plainly called for the exercise of the corrective function and powers of the Commissioner under the provisions of Section 41 and supplementary regulations set forth at the beginning of this opinion. It remains only to determine whether what the Commissioner did to correct this distorted picture was reasonable and proper.

We analyze and rationalize the Commissioner's action this way. It was clear to him that by 1942 a large part of the "reserve" in taxpayer's container deposit account was not supported by any real liability and, therefore, should be transferred to surplus and reported as income without further delay. The same was true of some fraction of the total additional deposits made in 1942 and 1943. In the Commissioner's view this aggregation of amounts to be added to income through 1943 equalled or exceeded the entire excess of current deposits over current repayments in 1942 and 1943 which the taxpayer sought to withhold from income and add to its container reserve. So the Commissioner telescoped corrective procedures by leaving the reserve as it stood at the end of 1941 and treating as taxable income the entire net increase of deposits in 1942 and 1943.

Perhaps these processess will be made clearer by actual calculation on an assumed, though not fanciful, basis. The Tax Court pointed out that from 1936 to 1951 it was the experience of the taxpayer that total repayments were 1.15 percent less than total deposits. On this theory, taxpayer itself suggests 1.15 percent of total pre-1942 deposits or a little more than $130,000 might be a proper transfer to surplus from pre-1942 accumulation. But this is only part of the picture. For, 1.15 percent of all deposits received in 1942 and 1943 must also be included to determine the total accumulation which on this theory would properly have been transferred to surplus and reported as income by the end of 1943. Thus augmented, the total of unreported income at the end of 1943 would be about $254,000 as compared with aggregate deficiencies of $264,000 actually assessed by the Commissioner for 1942 and 1943.

This $10,000 difference affords no substantial basis for complaint if we consider further that the use of 1.15 percent of total deposits to represent containers which never will be returned is rather favorable to the taxpayer. This is shown by the fact that at the end of 1943 more than 1½ percent of all containers distributed over the preceding years had not been returned.

The Tax Court said, in justification of the Commissioner's action,

> ... it has not been shown that the amount added to income [*i.e.*, the 1942 and 1943 excess deposits claimed as a 'reserve'] will ever be required to discharge any . . . liability [for refunds].

In the light of the entire foregoing analysis we cannot characterize that conclusion as clearly wrong. If the Commissioner's determination was an imprecise

approximation, the taxpayer who caused the difficulty by obviously improper accounting must at least show rather clearly that the Commissioner's result is unjust. This has not been shown here.

At the same time, it should be pointed out that the rather offhand device of simply requiring that any excess of deposits over refunds during the taxable year be reported as income cannot fairly be continued indefinitely, or very long, on no more showing than is in this record. Indeed, the point must be reached rather quickly where the bookkeeping reserve for past years is not unreasonably large, and thereafter a small percentage of deposits received during the taxable year itself will suffice without more to reflect the income derived during that year from dealings with containers.

Finally, taxpayer argues that the sums derived from deposits which were treated as income in 1942 and 1943 are subject to capital gains treatment under Section 117 [§ 1231 of the 1954 Code]. Taxpayer asks that these sums be treated as recognized gain resulting from the involuntary conversion of property held for the required statutory period. We dispose of this argument by stating that the facts and findings in this record do not bring the gain in controversy within Section 117. Whether in this type of case on a different record a capital gains treatment under Section 117 could be justified, we need not and do not decide.

The judgment will be affirmed.

Note

1. See also *Boston Consol. Gas Co.* v. *Commissioner*, 128 F.2d 473 (1st Cir. 1942), holding that unclaimed customers' deposits were income to the taxpayer in the year it transferred a reserve for such deposits to surplus; *Chicago, R. I., and P. Ry. Co.* v. *Commissioner*, 47 F.2d 990 (7th Cir. 1931), holding similarly as to a reserve for unclaimed overcharges. Why should such items be taxed as income in the year the taxpayer transfers the reserve to surplus? In the *Fort Pitt Brewing Co.* case, did the court include in income for 1942 and 1943 amounts that should have been included in earlier years? In *Lehman* v. *Commissioner*, ¶ 42,540 P-H Memo TC, involving unclaimed dividends held by an investment banking firm for its customers, the Commissioner asserted that the amounts should be taxed as soon as the applicable statute of limitations barred an action by the customer against the taxpayer. While the court held that the running of the statute of limitations was not decisive, it upheld the Commissioner in taxing the items at that time in the absence of proof by the taxpayer that the statutory period was not a reasonable one for determining whether the amounts would be claimed by the customer. How are excessive reserves for bad debts treated?

2. If the taxpayer in the *Fort Pitt Brewing Co.* case had "sold" the containers to its customers (for the same amount as the "deposits") under an agreement to "repurchase" them at the customers' option, would the tax treatment be different? If so, how does one decide whether the amount collected from the customer is a "deposit" or a "purchase price"? *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F.2d 6 (5th Cir. 1945), cert. den. 327 U.S. 806 (1946); *Nehi Beverage Co.* v. *Commissioner*, 16 T.C. 1114 (1951).

Do §§ 452 and 462 have any bearing on the *Fort Pitt Brewing Co.* problem?

DOBSON v. COMMISSIONER

Supreme Court of the U. S., 1943
320 U. S. 489, reh. den. 321 U. S. 231 (1944)

MR. JUSTICE JACKSON delivered the opinion of the Court.

These four cases were consolidated in the Court of Appeals. The facts of one will define the issue present in all.

The taxpayer, Collins, in 1929 purchased 300 shares of stock of the National City Bank of New York which carried certain beneficial interests in stock of the National City Company. The latter company was the seller and the transaction occurred in Minnesota. In 1930 Collins sold 100 shares, sustaining a deductible loss of $41,600.80, which was claimed on his return for that year and allowed. In 1931 he sold another 100 shares, sustaining a deductible loss of $28,163.78, which was claimed in his return and allowed. The remaining 100 shares he retained. He regarded the purchases and sales as closed and completed transactions.

In 1936 Collins learned that the stock had not been registered in compliance with the Minnesota Blue Sky Laws and learned of facts indicating that he had been induced to purchase by fraudulent representations. He filed suit against the seller alleging fraud and failure to register. He asked recission of the entire transaction and offered to return the proceeds of the stock, or an equivalent number of shares plus such interest and dividends as he had received. In 1939 the suit was settled, on a basis which gave him a net recovery of $45,150.63, of which $23,296.45 was allocable to the stock sold in 1930 and $6,454.18 allocable to that sold in 1931. In his return for 1939 he did not report as income any part of the recovery. Throughout that year adjustment of his 1930 and 1931 tax liability was barred by the statute of limitations.

The Commissioner adjusted Collins' 1939 gross income by adding as ordinary gain the recovery attributable to the shares sold, but not that portion of it attributable to the shares unsold. The recovery upon the shares sold was not, however, sufficient to make good the taxpayer's original investment in them. And if the amounts recovered had been added to the proceeds received in 1930 and 1931 they would not have altered Collins' income tax liability for those years, for even if the entire deductions claimed on account of these losses had been disallowed, the returns would still have shown net losses.

Collins sought a redetermination by the Board of Tax Appeals, now the Tax Court. He contended that the recovery of 1939 was in the nature of a return of capital from which he realized no gain and no income either actually or constructively, and that he had received no tax benefit from the loss deductions. In the alternative he argued that if the recovery could be called income at all it was taxable as capital gain. The Commissioner insisted that the entire recovery was taxable as ordinary gain and that it was immaterial whether the taxpayer had obtained any tax benefits from the loss deduction reported in prior years. The Tax Court sustained the taxpayer's contention that he had realized no taxable gain from the recovery.

The Court of Appeals [133 F.2d 732, 735] concluded that the "tax benefit theory" applied by the Tax Court "seems to be an injection into the law of an equitable principle, found neither in the statutes nor in the regulations." Because the Tax Court's reasoning was not embodied in any statutory precept, the court held that the Tax Court was not authorized to resort to it in determining whether the recovery should be treated as income or return of capital. It held as matter of law that the recoveries were neither return of capital nor capital gain, but were ordinary income in the year received. Questions important to tax administration were involved, conflict was said to exist, and we granted certiorari.

It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be "in accordance with law" and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts.

The court below thought that the Tax Court's decision "evaded or ignored" the statute of limitation, the provision of the Regulations that "expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year," [1] and the principle that recognition of a capital loss presupposes some event of "realization" which closes the transaction for good. We do not agree. The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction, it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital. Section 272(g) [see § 6214(b), 1954 Code] provides that:

> the Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency. . . .

The Tax Court's inquiry as to past years was authorized if "necessary correctly to redetermine" the deficiency. The Tax Court thought in this case that it was necessary; the Court of Appeals apparently thought it was not. This precipitates a question not raised by either counsel as to whether the court is empowered to revise the Tax Court's decision as "not in accordance with law" because of such a difference of opinion.

With the 1926 Revenue Act, Congress promulgated, and at all times since has maintained, a limitation on the power of courts to review Board of Tax Appeals (now the Tax Court) determinations. ". . . such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board . . . ." [2] However, even a casual survey of decisions in tax cases, now over 5,000 in number, will demonstrate that courts including this Court have not paid the scrupulous deference to the tax laws' admonitions of finality which they have to similar provisions in statutes relating to other tribunals. After thirty years of income tax history the volume of tax litigation necessary merely for statutory interpretation would seem due to subside. That it shows no sign of diminution suggests that many decisions have no value as precedents because they determine only fact questions peculiar to particular cases. Of course frequent amendment of the statute causes continuing uncertainty and litigation, but all too often amendments are themselves made necessary by court decisions. Increase of potential tax litigation due to more taxpayers and higher rates lends new importance to observance of statutory limitations on review of tax decisions. No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex.

[1] Treasury Regulations 118, § 39.43–2.

[2] Revenue Act of 1926, § 1003(b), 44 Stat. 9, 110, now Internal Revenue Code, § 7482(c)(2)

It is more difficult to maintain sharp separation of court and administrative functions in tax than in other fields. One reason is that tax cases reach circuit courts of appeals from different sources and do not always call for observance of any administrative sphere of decision. Questions which the Tax Court considers at the instance of one taxpayer may be considered by many district courts at the instance of others. . . .

The courts have rather strictly observed limitations on their reviewing powers where the limitation came into existence simultaneously with their duty to review administrative action in new fields of regulation. But this was not the history of the tax law. Our modern income tax experience began with the Revenue Act of 1913. The World War soon brought high rates. The law was an innovation, its constitutional aspects were still being debated, interpretation was just beginning, and administrators were inexperienced. The Act provided no administrative review of the Commissioner's determinations. It did not alter the procedure followed under the Civil War income tax by which an aggrieved taxpayer could pay under protest and then sue the Collector to test the correctness of the tax.[3] The courts by force of this situation entertained all manner of tax questions, and precedents rapidly established a pattern of judicial thought and action whereby the assessments of income tax were reviewed without much restraint or limitation. Only after that practice became established did administrative review make its appearance in tax matters.

Administrative machinery to give consideration to the taxpayer's contentions existed in the Bureau of Internal Revenue from about 1918 but it was subordinate to the Commissioner. In 1923, the situation was brought to the attention of Congress by the Secretary of the Treasury, who proposed creation of a Board of Tax Appeals, within the Treasury Department, whose decision was to conclude Government and taxpayer on the question of assessment and leave the taxpayer to pay the tax and then test its validity by suit against the collector. Congress responded by creating the Board of Tax Appeals as "an independent agency in the executive branch of the Government." The Board was to give hearings and notice thereof and "make a report in writing of its findings of fact and decision in each case." But Congress dealt cautiously with finality for the Board's conclusions, going only so far as to provide that in later proceedings the findings should be "prima facie evidence of the facts therein stated." So the Board's decisions first came before the courts under a statute which left them free to go into both fact and law questions. Two years later Congress reviewed and commended the work of the new Board, increased salaries and lengthened the tenure of its members, provided for a direct appeal from the Board's decisions to the circuit courts of appeals or the Court of Appeals of the Distrcit of Columbia, and enacted the present provision limiting review to questions of law.

But this restriction upon judicial review of the Board's decisions came only after thirteen years of income tax experience had established a contrary habit. Precedents had accumulated in which courts had laid down many rules of taxation not based on statute but upon their ideas of right accounting or tax practice. It was difficult to shift to a new basis. This Court applied the limitation, but with less emphasis and less forceful resolution of borderline cases in favor of adminis-

[3] See Cheatham v. United States, 92 U.S. 85, 89, 23 L. Ed. 561.

trative finality than it has employed in reference to other administrative determinations.

That neglect of the congressional instruction is a fortuitous consequence of this evolution of the Tax Court rather than a deliberate or purposeful judicial policy is the more evident when we consider that every reason ever advanced in support of administrative finality applies to the Tax Court.

The court is independent, and its neutrality is not clouded by prosecuting duties. Its procedures assure fair hearings. Its deliberations are evidenced by careful opinions. All guides to judgment available to judges are habitually consulted and respected. It has established a tradition of freedom from bias and pressures. It deals with a subject that is highly specialized and so complex as to be the despair of judges. It is relatively better staffed for its task than is the judiciary. Its members not infrequently bring to their task long legislative or administrative experience in their subject. The volume of tax matters flowing through the Tax Court keeps its members abreast of changing statutes, regulations, and Bureau practices, informed as to the background of controversies and aware of the impact of their decisions on both Treasury and taxpayer. Individual cases are disposed of wholly on records publicly made, in adversary proceedings, and the court has no responsibility for previous handling. Tested by every theoretical and practical reason for administrative finality, no administrative decisions are entitled to higher credit in the courts. Consideration of uniform and expeditious tax administrations require that they be given all credit to which they are entitled under the law.

Tax Court decisions are characterized by substantial uniformity. Appeals fan out into courts of appeal of ten circuits and the District of Columbia. This diversification of appellate authority inevitably produces conflict of decision, even if review is limited to questions of law. But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law.

To achieve uniformity by resolving such conflicts in the Supreme Court is at best slow, expensive, and unsatisfactory. Students of federal taxation agree that the tax system suffers from delay in getting the final word in judicial review, from retroactivity of the decision when it is obtained, and from the lack of a roundly tax-informed viewpoint of judges.

Perhaps the chief difficulty in consistent and uniform compliance with the congressional limitation upon the court review lies in the want of a certain standard for distinguishing "questions of law" from "questions of fact." This is the test Congress has directed, but its difficulties in practice are well known and have been subject of frequent comment. Its difficulty is reflected in our labeling some questions as "mixed questions of law and fact" and in a great number of opinions distinguishing "ultimate facts" from evidentiary facts.

It is difficult to lay down rules as to what should or should not be reviewed in tax cases except in terms so general that their effectiveness in a particular case will depend largely upon the attitude with which the case is approached. However, all that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court. Its decision, of course, must have "warrant in the record" and a reasonable basis in the law. But "the judicial

function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body." *Rochester Telephone Corp.* v. *United States*, 307 U.S. 125, 146, 59 S. Ct. 754, 764, 83 L. Ed. 1147; . . .

Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both law and facts. Whatever latitude exists in resolving questions such as those of proper accounting, treating a series of transactions as one for tax purposes, or treating apparently separate ones as single in their tax consequences, exists in the Tax Court and not in the regular courts, when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand. In view of the division of functions between the Tax Court and reviewing courts it is of course the duty of the Tax Court to distinguish with clarity between what it finds as fact and what conclusion it reaches on the law. In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.

The Government says that "the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation." But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact. Of course we are not here considering the scope of review where constitutional questions are involved. The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that "regarding the series of transactions as a whole, it is apparent that no gain was actually realized." It found that the taxpayer had realized no tax benefits from reporting the transaction in separate years. It said the question under these circumstances was whether the amount the taxpayer recovered in 1939 "constitutes taxable income, even though he realized no economic gain." It concluded that the item should be treated as a return of capital rather than as taxable income. There is no statute law to the contrary, and the administrative rulings in effect at the time tended to support the conclusion. It is true that the Board in a well considered opinion reviewed a number of court holdings, but it did so for the purpose of showing that they did not fetter its freedom to reach the decision it thought sound. With this we agree.

Viewing the problem from a different aspect, the Government urges in this Court that although the recovery is capital return, it is taxable in its entirety because taxpayer's basis for the property in question is zero. The argument relies upon § 113(b)(1)(A) [§ 1016(a)(1) of the 1954 Code], which provides for adjusting the basis of property for "expenditures, receipts, losses, or other items, properly chargeable to capital account." This provision, it is said, requires that the right to a deduction for a capital loss be treated as a return of capital. Consequently,

by deducting in 1930 and 1931 the entire difference between the cost of his stock and the proceeds of the sales, taxpayer reduced his basis to zero. But the statute contains no such fixed rule as the Government would have us read into it. It does not specify the circumstances or manner in which adjustments of the basis are to be made, but merely provides that "Proper adjustment . . . shall in all cases be made" for the items named if "properly chargeable to capital account." What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine. Evidently the Tax Court thought that the previous deductions were not altogether "properly chargeable to capital account" and that to treat them as an entire recoupment of the value of taxpayer's stock would not have been a "proper adjustment." We think there was substantial evidence to support such a conclusion.

The Government relies upon *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150, 75 L. Ed. 383, for the proposition that losses of one year may not offset receipts of another year. But the case suggested its own distinction:

> While [the money received] equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses. . . . They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. 282 U.S. at pages 363, 364, 51 S. Ct. at page 151, 75 L. Ed. 383.

It is also worth noting that the Court affirmed the Board's decision, which had been upset by the circuit court of appeals, and answered, in part, the contention of the circuit court that certain regulations were applicable by saying,

> . . . nor on this record do any facts appear tending to support the burden, resting on the taxpayer, or establishing that the Commissioner erred in failing to apply them." 282 U.S. at pages 366, 367, 51 S. Ct. at page 152, 75 L. Ed. 383.

It is argued on behalf of the Commissioner that the Court should overrule the Board by applying to this question rules of law laid down in decisions on the analogous problem raised by recovery of bad debts charged off without tax benefit in prior years. The court below accepted the argument. However, instead of affording a reason for overruling the Tax Court, the history of the bad debt recovery question illustrates the mischief of overruling the Tax Court in matters of tax accounting. Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off.*

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* In one of the leading cases on this issue, the court said:

"It is to be noted that only where the bad debt has been charged off and allowed as a deduction is it to be included in income when collected The taxpayer is thus given an option by the statute and, only where he exercises the option, is he required to account for the collection as income. Where he does exercise it, however, by charging off the debt as worthless in his return, he is bound by the election so made. . . . When he collects the debt thereafter he must account for the collection as income; for by electing to charge it off, he is precluded from treating it as capital or its collection as the restoration of capital and under the existing regulation impliedly consents that it be treated as income When a debt has thus been charged off in one year and collected in a subsequent year, the fact that such charge off did or did not result in tax benefit, cannot be considered in connection with the taxability of its collection as income both because the taxability is determined by the charge off and not by the tax benefit accruing therefrom and because each taxable year must be regarded as an independent unit for income tax purposes. Burnet v. Sanford & Brooks Co , 282 U.S. 359, 51 S. Ct. 150, 75 L. Ed. 383." (Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44, 46 (4th Cir. 1942).) [Ed.]

The Tax Court had first made a similar holding, but had come to hold to the contrary. Substitution of the court's rule for that of the Tax Court led to such hardships and inequities that the Treasury appealed to Congress to extend relief.[4] It did so.[5] The Government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemption recoveries are taxable as income. We do not find that significant in the amendment. A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a "theoretically proper" rule which distorted the taxpayer's income. Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case.[6]

The Government also suggests that "If the tax benefit rule were judicially adopted the question would then arise of how it should be determined," and the difficulties of determining tax benefits, it says, create "an objection in itself to an attempt to adopt such a rule by judicial action." We are not adopting any rule of tax benefits. We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting.

There is some difference in the facts of these cases. In two of them the Tax Court sustained deficiencies because it found that the deductions in prior years had offset gross income for those years and therefore concluded that the recoveries must to that extent be treated as taxable gain. The taxpayers object that this conclusion disregards certain exemptions and credits which would have been available to offset the increased gross income in the prior years, so that the deductions resulted in no tax savings. In determining whether the recoveries were taxable

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[4] Mr. Randolph Paul, Tax Adviser to the Secretary of the Treasury, in a statement to the House Committee on Ways and Means said: "The Secretary has pointed out that wartime rates make it imperative to eliminate as far as possible existing inequities which distort the tax burden of certain taxpayers. I should like to discuss the inequities which the Secretary mentioned, as well as a few additional hardships. . . .

"(c) *Recoveries of bad debts and taxes.*—If a taxpayer who has taken a bad debt deduction later receives payment of such debt, such payment must be included in his income even though he obtained no tax benefit from the deduction in the prior year. While this result is theoretically proper under our annual system of taxation, it may produce severe hardships in certain cases through a distortion of the taxpayer's real income. At the same time, any departure from our annual system of taxation always produces administrative difficulties which serve to impede the collection of taxes.

"It is believed that the hardships can be removed and the administrative difficulties kept to a minimum by excluding from income amounts received in payment of the debt to the extent that the deduction on account of the debt in the prior year did not produce a tax benefit. The troublesome question whether a benefit resulted should be determined pursuant to regulations prescribed by the Commissioner with the approval of the Secretary. It is also suggested that this treatment be extended to refunds of taxes previously deducted." (Hearings before Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess, Vol. I. 80, 87–88.)

[5] I.R.C., Sec. 22(b) (12). [§ 111, 1954 Code.]

[6] The question of whether a recovery is properly accounted for as income in the year received or should be related to a previous reported deduction without tax benefit is one with a long history and much conflict. It arises not only in case of recoveries of previously charged off bad debts and recoveries of the type we have here. It is also present in case of refund of taxes or cancellation of expenses or interest previously reported as accrued, adjustments of depreciation and depletion or amortization, and other similar situations.

gain, however, the Tax Court was free to decide for itself what significance it would attach to the previous reduction of taxable income as contrasted with reduction of tax. The statute gives no inkling as to the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment. In No. 47 the decision of the Tax Court was upheld by the court below, and in that case the judgment is affirmed. In Nos. 44, 45, and 46, the Court of Appeals reversed the Tax Court, and for the reasons stated its judgments in those cases are reversed.

Reversed.

Note

1. Why is income realized on the recovery of a bad debt or other item that has been deducted, even when a tax benefit was obtained by the charge-off? See *Helvering* v. *State-Planters Bank & Trust Co., supra*, p. 755n. If an item *could* have been deducted from income, with tax benefit, but was not, is a subsequent recovery taxable income? Recall that § 1016(a)(2) requires the basis of property to be adjusted downward for depreciation that was "allowable" in past years, whether deducted or not. *Supra*, p. 269. Is the recovery of a debt that could have been deducted in an earlier year distinguishable from the recovery of "allowable," but undeducted, depreciation when the asset is sold?

2. Is the recovery taxable only to the extent of the tax actually saved in the earlier year, or is it taxable in full so long as the deduction was used in full, no matter how small the savings in tax? If the latter, is there any sound reason for requiring a tax benefit at all? Section 111, which covers many but not all of the tax benefit situations, allows the Commissioner to promulgate a method of applying the tax benefit doctrine to the recoveries that are within its scope. See Regs. 118, Sec. 39.22(b)(12)-1, for some complexities that lurk in "the" tax benefit doctrine. In *First National Bank* v. *Commissioner*, 22 T.C. No. 27 (1954), it was held that the deduction of a bad debt produces tax benefit, so that a recovery may not be excluded under § 111, if the deduction was *used* on the return to reduce taxable income, even though the taxpayer had other deductions or exemptions for the same year, not listed on the return, that could have been used instead. Eighteen months after the *Dobson* case was decided, the Treasury abandoned its view that the tax benefit doctrine was restricted to Section 111 items and amended the regulations to embrace also "all other items subject to the rule of exclusion." The scope of the doctrine remains obscure.

3. Note how the Court distinguished the *Sanford & Brooks* case, *supra*, p. 737, where the proceeds of a contract were taxed as income despite the fact that the expenses of the contract had been deducted in years of loss. Is the distinction persuasive?

4. In *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523 (1943), the Court refused to read a tax benefit qualification into the rule of § 113(b)(1)(B) of the 1939 Code (as it then read) that basis must be reduced by depreciation "allowed." If depreciation was claimed and not disallowed, the Court held that basis must be reduced whether the claimed depreciation produced tax benefit or not. By the Revenue Act of 1950, § 113(b) was amended to apply the tax benefit principle to adjustments for excessive depreciation. *Supra*, p. 269. As pointed out above, however, "allowable" depreciation reduces basis regardless of tax benefit.

5. Even if the year of deduction produced no tax benefit, the taxpayer may have enjoyed one in another year by reason of an operating loss or capital loss carry-over. The broader the scope of these carry-overs, and the longer the period to which they apply, the more frequently will a deduction produce tax benefit in some year. See generally Tye, "The Tax Benefit Doctrine Re-examined," 3 *Tax L. Rev.* 329 (1948); Tye, "Tax Benefit Developments," 2 *id.* 106 (1946); Plumb, "The Tax Benefit Rule Today," 57 *Harv. L. Rev.* 129 (1943); Plumb, "The Tax Benefit Rule Tomorrow, *id.* 675 (1944).

6. On the *Dobson* case's treatment of the proper scope of judicial review of the Tax Court, see Paul, "Dobson v. Commissioner: The Strange Ways of Law and Fact," 57 *Harv. L. Rev.* 753 (1944). This doctrine led to an announcement by the Court of Appeals for the Second Circuit that it would affirm a Tax Court decision that would be reversed if made by a federal district court, *Kirschenbaum* v. *Commissioner*, 155 F.2d 23 (2d Cir. 1946). In 1948, Congress amended what is now § 7482(a), to provide that Tax Court decisions shall be reviewed "in the same manner and to the same extent" as decisions of the federal district courts in civil cases tried without a jury. See Rice, "Law, Fact, and Taxes: Review of Tax Court Decisions Under Section 1141 of the Internal Revenue Code," 51 *Col. L. Rev.* 439 (1951). Even earlier, however, the Supreme Court's record on reviewing the Tax Court led Randolph Paul to remark: "For the time being the precise position of the Supreme Court on the *Dobson* issue cannot be determined by compass, the stars, or even the use of radar." Paul, "The Place of the Courts in the Taxing Process," 39 *Proc. of Nat'l. Tax Assoc.* 462, 466 (1946).

7. On the diversification of appellate authority over the Tax Court among eleven Courts of Appeals, see *infra*, p. 843.

3. *The Correction of Errors*

BENNET v. HELVERING

U. S. Court of Appeals, Second Circuit, 1943
137 F.2d 537

Before L. HAND, AUGUSTUS N. HAND, and FRANK, Circuit Judges.

L. HAND, Circuit Judge.

The taxpayers—husband and wife—appeal from a decision of the Tax Court refusing to allow them a deduction from their income tax for the year 1935, based upon the conceded fact that in that year fifty shares of stock of which the husband was the owner became worthless. The amount of the loss is not disputed, and the case may be simplified without prejudice to the Treasury by saying that it involves only a single question of law: May a taxpayer, who has received property, which was taxable as income when received,* but on which he has innocently failed ever to pay any tax, deduct its loss in a later year when it becomes worthless? The Commissioner argued, and the Tax Court held, that the privilege of making such a deduction was a correlative of the payment of a tax upon the income when originally received, and that, since the husband had failed to pay any tax upon the shares at any time, he could not deduct the loss in the year when they became worthless.

The situation must be distinguished from that of a claim for refund either by action of indebitatus assumpsit (*Bull* v. *United States*, 295 U.S. 247, 55 S. Ct. 595, 79 L. Ed. 1421), or by claim for refund (*R. H. Stearns Co.* v. *United States*, 291 U.S. 54, 54 S. Ct. 325, 78 L. Ed. 647; *Stone* v. *White*, 301 U.S. 532, 57 S. Ct. 851, 81 L. Ed. 1265). In both of these the taxpayer asks a return of money paid by him on the assumption that the Treasury unjustly retains it; and for that reason his claim has been held to be subject to a set-off to the extent that he has escaped payment of an earlier tax which would have been in fact due, if the earlier assessment had been properly computed, even though that involves in effect a reassessment.† In

* As compensation for services. [Ed.]

† This is the doctrine of recoupment, the present status of which is considered in the Electric Storage Battery Co. case, *infra*, p. 762 and in the Note which follows it. [Ed.]

the case at bar the taxpayers ask no relief; it is the Commissioner who seeks to assess them, and in so doing to deny them a deduction whose propriety is undeniable on the facts: the shares were received as part of the taxpayer's income, they became worthless in 1935. Such a loss is concededly within the statute unless some reason, which it does not express, takes it out. That reason must be sufficient to overcome the bar of the statute against reassessment of an income tax more than three years after the return has been filed. § 275(a) [now § 6501(a)]. In several decisions we have held that the fact that the taxpayer has in the past omitted an item of charge from his gross income and has therefore never paid any tax upon it, does not toll the statute. *Salvage* v. *Commissioner*, 2 Cir., 76 F.2d 112, affirmed *Helvering* v. *Salvage*, 297 U.S. 106, 56 S. Ct. 375, 80 L. Ed. 511; *Commissioner* v. *Union Pacific R. Co.*, 2 Cir., 86 F.2d 637; *Schmidlapp* v. *Commissioner*, 2 Cir., 96 F.2d 680, 683. Of course, if the omission has been consciously made, the return is fraudulent, and the tax may be assessed at any later time. § 276(a) [now § 6501 (c)]. We can see no reason why an innocent mistake should deprive the taxpayer of protection; statutes of limitation are passed precisely to put an end to the reconsideration of what has been once heard and decided; they presuppose that the original decision may have been erroneous.

Some courts have reached the opposite result by holding the taxpayer to the truth of what he declared in his first return, when the second tax is assessed: this, on principles of estoppel. *Crane* v. *Commissioner*, 1 Cir., 68 F.2d 640; *Commissioner* v. *Farren*, 10 Cir., 82 F.2d 141; *Alamo National Bank* v. *Commissioner*, 5 Cir., 95 F.2d 622; *Doneghy* v. *Alexander*, 10 Cir., 118 F.2d 521. The basic difficulty with this is that, although adopted in the name of equity, it does not do equity unless supplemented by what in the end comes to a reassessment of the first tax. It by no means follows that to cancel a deduction in a later year will restore the situation to what it would have been, if the tax had been assessed correctly in the first year and the deduction allowed in the second; on the contrary, it seldom, if ever, will do so. It is only in case one supplements the doctrine by limiting it to those cases in which the taxpayer gained by the omission in the first year as much as, or more than, what he will lose by cancelling the deduction in the second, that it will work out equitably, and then only on the assumption that it is inequitable in the circumstances to allow the defense of the statute of limitations. The courts which have adopted this theory, have not shown any disposition to engraft such a condition upon it; and if they had, any logical force it might have had would have disappeared, for it would emerge for what it is, if it is to be an equitable doctrine at all: *i. e.* an excuse for reopening the earlier assessment in the face of the statute. Strictly, this point does not come up in the case at bar, not having been raised before the Tax Court, as the Commissioner concedes. *Helvering* v. *Salvage*, *supra*, 297 U.S. 106, 109, 56 S. Ct. 375, 80 L. Ed. 511. Nevertheless, it fits so closely upon the theory on which he relies, that it has been necessary to consider it.

That theory is, not that the taxpayer was here "estopped" as to any fact by his earlier return, but that if the earlier assessment were made upon one theory of law, the same theory must be consistently followed thereafter: to be specific, that if the taxpayer's earlier tax was assessed on the assumption that the receipt of the shares was not income—even if the taxpayer had no part in inducing that error—justice demands that that assumption shall be carried over into any future year in

which the shares again figure in the taxpayer's return. Some decisions have so held; it is a kind of estoppel as to the law. In *Comar Oil Co.* v. *Helvering*, 8 Cir., 107 F.2d 709, for example, the Treasury was allowed to cancel a deduction on the ground that it had been already once allowed and could not be allowed a second time, although there was no pretence of any estoppel as to the facts, for the Commissioner had acted with full knowledge of them. In *Dixie Margarine Co.* v. *Commissioner*, 6 Cir., 115 F.2d 445, and *Gooch Milling & Elevator Co.* v. *Commissioner*, 8 Cir., 133 F.2d 131, the courts applied the same doctrine conversely. The taxpayer was allowed to assert an outlawed refund to cancel a corresponding item in a deficiency assessed against it in a later year. On the other hand, we have already three times refused to accept such a doctrine (*Bigelow* v. *Bowers*, 68 F.2d 839; *Lembcke* v. *Commissioner*, 126 F.2d 940; *Schmidlapp* v. *Commissioner*, *supra*, 96 F.2d 680); and so has the First Circuit, twice (*Commissioner* v. *Saltonstall*, 124 F.2d 110; *Countway* v. *Commissioner*, 127 F.2d 69). With deference it seems to us, not only to have all the vices of an estoppel as to the facts, but not to have even the excuse which that doctrine has: *i.e.* that in making his return a taxpayer does represent that it contains his complete gross income; something which the Commissioner cannot know. Were an assessment a judgment, there might be some basis for an estoppel of record in both situations: the estoppel as to the law depending upon how far questions of law are regarded as subject to the doctrine of res judicata. But estoppels by judgment have nothing to do with the equity of the particular case, and indeed often operate very harshly; and none of the decisions on this subject have ever suggested that the Commissioner's assessment creates an estoppel by judgment. They have been uniformly based upon some supposed equity.

It may appear plausible that, if the Treasury is to be allowed to reopen a barred assessment in order to interpose a set-off to a claim for refund, it should be allowed to do the same thing in order to assess a tax. That privilege in cases of refund was based altogether upon the historical descent of the action of indebitatus assumpsit, and it may be thought that history should not remain an excuse for denying equity. But there lies behind that history in this instance something more real than accident. When a person seeks to recover money which he has paid, it does not offend our sense of fair play that before he is allowed to unravel what he has done, he should submit to the reopening of any past related transactions between him and the person against whom he is moving. But in assessing a tax, the Treasury is not on the defensive; it has the affirmative, it must bring the case within the statute which imposes the liability. If in order to do so, it must reopen a past transaction between the taxpayer and itself, which the law has declared definitively closed, its position is equitably much weaker than in the case of a refund. Such distinctions depend, not upon logic, but upon conventions which make up the greater part of what we consider just and unjust; they are not for that reason the less imperative, rather the contrary. In what we have said we do not rely upon § 272(g) [now § 6214(b)] or question the jurisdiction of the Tax Court.

Order reversed; deficiency expunged.

Note

1. If the omission *had* been fraudulent, could the taxpayer insist that the Commissioner

reopen the earlier year rather than disallow the deduction? (The 6-year statute on criminal prosecution might have run, and a deduction in the later year might more than counterbalance the tax, penalty, and interest on the earlier deficiency.)

2. The position taken in this case was later endorsed by the Court of Appeals for the First Circuit in the *Ross* case, *supra*, p. 661. See also *Commissioner* v. *Mellon*, 184 F.2d 157; *Fahs* v. *Florida Machine & Foundry Co.*, *supra*, p. 476; Maguire & Zimet, "Hobson's Choice and Similar Practices in Federal Taxation," 48 *Harv. L. Rev.* 1281 (1935). In the section on stock dividends, we saw that one of the purposes of § 307(a) was to restore a measure of consistency to the tax treatment of sales of both original and dividend shares after the regulations governing the allocation of basis, upon which both Commissioner and taxpayer had frequently relied, were invalidated by the *Koshland and Gowran*, cases, *supra*, p. 525. One of the problems was that a taxpayer might have previously availed himself of the old regulation by allocating part of the basis of the original shares to dividend shares, computing gain accordingly on the sale of his dividend shares. With the invalidation of the regulations, he would be able to claim his original basis on a sale of the original shares, and, under cases like *Bennet* v. *Helvering*, there would apparently be no estoppel. The rules of § 307(a) are applied to require consistency of treatment in these circumstances.

3. As the court points out, taxpayers have sometimes been held to a duty of consistency by other courts. For example, in *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F.2d 6 (5th Cir. 1945), cert. den. 327 U.S. 806 (1946), the taxpayer claimed that amounts received from customers for containers represented the sales price of the articles rather than deposits. Consequently, the taxpayer argued, the amounts should have been reported as income in earlier years. In fact, the amounts had been excluded from income in the earlier years on the ground that they were deposits, and the government took the position that income was realized when the deposit account was later transferred to surplus. (See again the *Fort Pitt Brewing Co.* case, *supra*, p 744). The court held that having represented the amounts as deposits, the taxpayer could not later assert that they were not:

> To raise this duty of consistency in tax accounting we do not think a willful misrepresentation need be proven, or all the elements of a technical estoppel. It arises rather from the duty of disclosure which the law puts on the taxpayer, along with the duty of handling his accounting so it will fairly subject his income to taxation. Having, though mistakenly, so represented a transaction as to defer taxation on it to a later year he ought not, when the time for taxation under his view of it comes, to be allowed to assert the tax ought to have been levied in the former year if it is then too late so to levy it. (152 F.2d at 8.)

This was a refund case, so perhaps the Court of Appeals for the Second Circuit would have arrived at the same result, but the Fifth Circuit treated the doctrine as one of general application. Indeed, the Second Circuit itself, only three years before it decided the *Bennet* case, held that income was realized on the collection of an account receivable because it had been charged off, though erroneously, in an earlier year. *Kahn* v. *Commissioner*, 108 F.2d 748 (2d Cir. 1940). See also *Ben Bimberg & Co.* v. *Helvering*, 126 F.2d 412 (2d Cir. 1942), where Judge L. Hand, discussing the power of the Commissioner to tax as income a refund of a tax that was erroneously deducted in an earlier year, said:

> The taxpayer continues to insist upon retaining the profit of the deduction so long as he does not consent to a reopening of the assessment; and patently he is not entitled to both deduction and exemption. Nor should he be permitted to reopen it if he would, because that would give him an option to throw the item in whichever year would profit him more. (126 F.2d at 413.)

See, however, *Streckfus Steamers, Inc.* v. *Commissioner*, 19 T.C. 1 (1952), where a taxpayer on the accrual basis deducted (erroneously, under the *Dixie Pine Products Co.* case, *supra*, p. 731) a state sales tax, liability for which it was contesting and which it did not pay. The Commissioner sought to tax as income the amount deducted when,

in a later year, the taxpayer was held not liable for the sales tax. The Tax Court held for the taxpayer.

4. If estoppel is rejected, as in the *Bennet* case, would it nevertheless be possible to hold that the taxpayer's basis for the stock is zero, on the ground that he has no "cost" under § 1012 because he neither paid for the stock nor reported it as income? If his basis is zero, he could have no loss on a sale of the stock, because under § 1001(a) there is no loss unless the adjusted basis exceeds the sales price. Would it be possible, consistently with the *Bennet* case, to allow a loss of $5,000 if stock worth that amount on acquisition became worthless, but to find a profit if the same stock had been sold for $10?

The Tax Court has several times expressed the view that an "income item" has no basis if it is not "taken into income," but recently indicated it was not so sure of this position in the light of the *Bennet* and *Ross* cases. *Bryan* v. *Commissioner*, 16 T.C. 972, 981 (1951). If the Tax Court adheres to its position, would property received as compensation have a basis (a) if it was reported as income but untaxed because of offsetting deductions or credits, or (b) if the recipient was not required to file a return because his gross income was less than the minimum amount for that year?

5. When a taxpayer shifts from one method of accounting to another, various interim adjustments should be made to prevent the same items from being taxed or deducted twice and to prevent other items from being passed over altogether. To take the *Herberger* case, *supra*, p. 680, as an example, unless the taxpayer, after shifting to an accrual basis, is allowed to deduct accounts payable that should have been accrued as expenses in earlier years, these expenses will never be deducted. Contrariwise, unless accounts receivable that should have been accrued in earlier years are taken into income when paid, they will never be taxed. And if the taxpayer is allowed to use its actual opening inventory in computing income for the first year it goes on an accrual basis, it will be deducting the cost of the same goods twice. When the taxpayer changed from one *proper* accounting method to another, the Commissioner's consent was always required, and this would be conditioned on proper interim adjustments. Regs. 118, Sec. 39.41–2. But it was doubtful before 1954 whether such adjustments would be required if a taxpayer who was *improperly* reporting on one method was required to change to a proper method; and if the earlier years were closed, some items might be taxed or deducted twice or frozen out altogether. *Commissioner* v. *Dwyer*, 203 F.2d 522 (2d Cir. 1953); *Hughes* v. *Commissioner*, 22 T.C. No. 1 (1954). Section 481 of the 1954 Code provides for adjustments whether the previous method of accounting was proper or not; and it contains special provisions to ease the transition where a bunching of taxable income in the year of change would otherwise result.

6. The assertion of estoppel against the government is likely to arise primarily when there has been reliance on official advice. For this problem, see *infra*, p. 818. See also *Vestal* v. *Commissioner*, 152 F.2d 132 (D.C. Cir. 1945).

ROTHENSIES v. ELECTRIC STORAGE BATTERY CO.

Supreme Court of the U. S, 1946
329 U. S. 296

MR. JUSTICE JACKSON, delivered the opinion of the Court.

This case represents an effort, thus far successful, to obtain advantage by way of recoupment of a claim for tax refund long since barred by the statute of limitations. The facts of this singular situation are not in dispute. From April 1919 to April 1926 the Electric Storage Battery Company paid excise taxes on the sale of storage batteries in the belief, shared by the Government, that such sales were subject to tax. In July of 1926 the company asserted otherwise and filed a refund claim. It asked refund only of that part of the taxes which it had paid between 1922 and 1926. Refund of the taxes paid earlier which the company now seeks

to recoup were then barred by the statute of limitations and no claim ever has been filed for their refund and no action ever was begun for their recovery. Suit was brought, however, against the Collector for refund of the taxes paid after July 1922; judgment therefor was obtained in the district court, *Electric Storage Battery Co.* v. *McCaughn*, 52 F.2d 205; 54 F.2d 814, and affirmed by the Circuit Court of Appeals, 3 Cir., 63 F.2d 715. The Government finally settled by refund of $1,395,515.35, of which $825,151.52 represented tax and the balance interest.

During the years that the refunded excise tax was being collected, the taxpayer deducted it from income before calculation of its income tax, thereby deriving substantial benefits. The Commissioner, therefore, treated the refund as income for 1935, the year in which it was received, and because of it assessed additional income and excess profits taxes which with interest thereon totaled $229,805.34. The taxpayer paid the deficiency, filed claim for refund, and after it was rejected sued the Collector. It contended that the refund from the Government was not income to the taxpayer but that if it were so considered taxpayer should be permitted, as against the additional tax caused by its inclusion, to recoup the amount of the barred excise taxes which it had paid between 1919 and 1922. Both courts below correctly held that the refund was properly assessed as income. D.C, 57 F. Supp. 731; 3 Cir., 152 F.2d 521. *Cf. Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 64 S. Ct. 596, 88 L. Ed. 725; *Freihofer Baking Co.* v. *Commissioner*, 3 Cir., 151 F.2d 383. Both have held, however, that the income tax liability for 1935 should be extinguished by recoupment of the 1919 to 1922 excise taxes. The gravity of this holding to the administration of the tax laws led us to grant certiorari. *Rothensies* v. *Electric Storage Battery Co.*, 327 U. S. 774, 66 S. Ct. 825.

It is not contended that there is any statutory warrant for allowing barred tax refund claims by way of recoupment or otherwise.[1] Authority for it is said to be found in case law and taxpayer relies chiefly on two decisions of this Court, *Bull* v.*United States*, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421, and *Stone* v. *White*, 301 U.S. 532, 57 S. Ct. 851, 81 L. Ed. 1265. The essence of the doctrine of recoupment is stated in the *Bull* case; "Recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." 295 U.S. 247, 262, 55 S. Ct. 700, 79 L. Ed. 1421. It has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

The application of this general principle to concrete cases in both of the cited decisions is instructive as to the limited scope given to recoupment in tax litigation. In both cases a single transaction constituted the taxable event claimed upon and the one considered in recoupment. In both, the single transaction or

[1] Indeed, the applicable provisions of the Internal Revenue Code seem to direct a result opposite to that asked by respondent. Section 3774 provides that "A refund of any portion of an internal-revenue tax (or any interest, penalty, additional amount, or addition to such tax) made after the enactment of this Act, shall be considered erroneous—(a) if made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; . . . ." Section 3775(b) provides, "A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 3774." And *Cf.* McEachern v. Rose, 302 U.S. 56, 58 S. Ct. 84, 82 L. Ed. 46. [See § 6514(a) of the 1954 Code.]

taxable event had been subjected to two taxes on inconsistent legal theories, and what was mistakenly paid was recouped against what was correctly due. In *Bull* v. *United States,* the one taxable event was receipt by executors of a sum of money. An effort was made to tax it twice—once under the Income Tax Act as income to the estate after decedent's death and once under the Estate Tax Act as part of decedent's gross estate. This Court held that the amount of the tax collected on a wrong theory should be allowed in recoupment against an assessment under the correct theory.[2] In *Stone* v. *White,* likewise, both the claim and recoupment involved a single taxable event, which was receipt by an estate of income for a period. The trustees had paid the income tax on it but this Court held it was taxable to the beneficiary. Assessment against the beneficiary had meanwhile become barred. Then the trustees sued for a refund, which would inure to the beneficiary. The Court treated the transaction as a whole and allowed recoupment of the tax which the beneficiary should have paid against the tax the Government should not have collected from the trustees. Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this Court in tax cases.

The Government has argued that allowance of the claim of recoupment involved here would expand the holding in the *Bull* case. The Circuit Court of Appeals agreed that in the *Bull* case "The main claim and recoupment claim were more closely connected than they are here." *Electric Storage Battery Co.* v. *Rothensies,* 3 Cir., 152 F.2d 521, 524. But the court nevertheless allowed the claim because it considered that this Court had introduced the doctrine of recoupment into tax law and that it was "based on concepts of fairness." 152 F.2d 521, 524. It said it saw no reason for narrowly construing the requirement that both claims originate in the same transaction. We think this misapprehends the limitations on the doctrine of recoupment as applied to tax law and it leads us to state more fully reasons for declining to expand the doctrine beyond the facts of the cited cases.

It probably would be all but intolerable, at least Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.

We have had recent occasion to point out the reason and the character of such limitation statutes.

Statutes of limitation, like the equitable doctrine of laches, in their conclusive effects are designed to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them. (*Order of Railroad Telegraphers* v. *Railway Express Agency,* 321 U.S. 342, 348, 349, 64 S. Ct. 582, 586, 88 L. Ed. 788.)

They are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the voidable [avoidable] and unavoidable delay. They

[2] But the Court emphasized that refund of the incorrect tax was not barred by the statute at the time the Government proceeded for collection of the correct tax.

have come into the law not through the judicial process but through legislation. (*Chase Securities Corp.* v. *Donaldson*, 325 U.S. 304, 314, 65 S. Ct. 1137, 1142, 89 L. Ed. 1628.)

As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out.[3] They tempt the equity-minded judge to seek for ways of relief in individual cases.

But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters. In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute, at least as closely as does the item involved here. *Cf. Hall* v. *United States*, 43 F. Supp. 130, 95 *Ct.Cl.* 539. The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup. This case provides evidence of the extent to which this would go. When this suit was brought in 1943, the claim pleaded as a recoupment was for taxes collected over twenty years before and for over sixteen years barred by the statute. That claims dead so long can be resurrected under this doctrine, is enough to show its menace to the statute of limitations—at least as to those taxpayers whose affairs by accident or design take such shape that they can avail themselves of recoupment remedies. Moreover, we have held that the Tax Court has no jurisdiction to consider recoupment. *Gooch Milling and Elevator Co.* v. *Commissioner*, 320 U.S. 418, 64 S. Ct. 184, 88 L. Ed. 139. Hence, the availability of the remedy would depend on diverting the litigation to the district courts.

We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the statute of limitations, it is for Congress rather than for the Courts to create and limit them.

The judgment below is reversed.

Reversed.

Mr. Justice MURPHY is of the opinion, in which Mr. Justice BLACK and Mr. Justice RUTLEDGE join, that the judgment below should be affirmed. He believes that the claims for refund of the illegal assessments exacted from 1919 to 1922 arise out of the same subject matter as was involved in the Government's demand for additional taxes for 1935, thereby making applicable the rule of *Bull* v. *United States*, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421.

Note

1. As Mr. Justice Jackson points out, the Supreme Court held in the *Gooch Milling*

[3] In American Light & Traction Co. v. Harrison, 7 Cir., 142 F.2d 639, 154 A.L.R. 1042, the court did not allow recoupment to the Government. But judiciously, it said, "Although here a hardship on the Government results from the taxpayer's inconsistency, the correlative provisions of this same statute will, in the converse of the instant situation, work an equal hardship on the taxpayer." 142 F.2d 639, 643. Whether or not Sections 3774 and 3775(b), *supra*, note 1, be taken to compel the conclusion we reach in this case, the court's recognition that both parties to taxation are affected impartially, though perhaps harshly, by policy of repose has application here. It may easily be overlooked, when the unfairness of the Government's retaining incorrectly collected monies of respondent is stressed, that the statute of limitations is primarily an instrument of fairness.

and Elevator Co. case that the Tax Court has no jurisdiction to allow recoupment. The Court based its decision on what is now § 6214(b):

> The Tax Court in redetermining a deficiency . . . for any taxable year . . . shall consider such facts with relation to the taxes for other years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

Refund cases in the district courts and Court of Claims were distinguished because they are "tribunals possessing general equity jurisdiction." With the doctrine limited to these courts, it may be that judicial resistance to its application may increase in order to prevent "forum-shopping." But see McConnell, "The Doctrine of Recoupment in Federal Taxation," 28 *Va. L. Rev.* 577 (1942).

2. In *McEachern* v. *Rose*, 302 U.S. 56 (1937), the government was not allowed to set off a barred deficiency against a proper refund. Under §§ 6401(a) and 6402(a), if the taxpayer paid the barred deficiency, the payment would have to be refunded, and the crediting of a refund against a barred deficiency in such circumstances is forbidden by § 6514(b). The Court decided that recoupment by the government was barred by these statutory provisions. (Query: Why was recoupment allowed to the government in *Stone* v. *White*, summarized in the *Electric Storage Battery Co.* case?) As to recoupment by the taxpayer, it should be noted that § 6514(a) forbids crediting an overpayment that cannot be refunded because of the statute of limitations against a deficiency for a year that is still open. See notes 1 and 3 in the *Electric Storage Battery Co.* case.

BRENNAN v. COMMISSIONER

Tax Court of the U. S., 1953
20 T.C. 495

TIETJENS, Judge:

The fact situation before us is not complicated. In bare outline it is as follows.

The petitioner purchased bonds in 1944 and sold them in 1945. He claimed a deduction on his 1944 return of $35,514.25 representing amortizable bond premium allowed as a deduction by section 125,* adjusted his basis in a like amount and reported on his 1945 return a corresponding increase in gain from the sale in that year. The respondent reversed these steps, determined a deficiency for 1944 and granted a refund for 1945. The petitioner accepted the refund which was premised on the increased basis of the bonds in 1945. The petitioner also successfully contested the 1944 deficiency in a proceeding in this Court. The respondent has determined a deficiency for 1945.

Concededly, unless section 3801 † permits the adjustment now sought by the respondent, the statute of limitations has run for 1945. In approaching problems like this we have held that "the party who invokes an exception to the basic statutory limitation period must . . . assume the burden of proving all of the prerequisites to its application." *D.A. MacDonald,* 17 T.C. 934, 940. The burden is thus on the respondent.

The shape of the argument permits us to attack the problem much the same as was done in the *MacDonald* case. Both parties argue the question whether the action of the petitioner in accepting and retaining the refund in 1945 amounted to the maintenance of an inconsistent position, one of the prerequisites to the ap-

* Now § 171(a) of the 1954 Code. [Ed]
† Now, somewhat modified, §§ 1311-15 of the 1954 Code. [Ed.]

plication of section 3801. For reasons hereafter stated, however, we need not decide the question of inconsistency.

Section 3801 does not purport to permit the correction of all errors and inequities. It sets forth in detail the conditions which must be met before the ordinary bar of limitations is lifted and adjustment is permitted. Some of those conditions have been met here, but we do not think all of them have. Section 3801(b) sets out five situations in the circumstances of which adjustments are permitted. The respondent relies on (b)(2) and (b)(5).

We do not think the facts bring this case within (b)(2).‡ Our determination in Docket No. 14104 allowed a deduction to the taxpayer in 1944 but we do not see that the deduction allowed was one "which was erroneously allowed to the taxpayer for another taxable year" as required by the statute. The taxpayer only claimed the deduction in a single year, 1944, and that was the year in which our determination allowed it. True, the amount of the deduction was a factor in adjusting the basis of the bonds for the purpose of determining the taxable gain on their sale in 1945, but that is a different matter from claiming "a deduction" in 1945.

Neither do we think (b)(5)§ is applicable. The prerequisite for calling that subsection into play is a determination (our decision in Docket No. 14104) which "determines the basis of property . . . for gain or loss on a sale . . . ." But our decision in Docket No. 14104 did not determine the basis of the bonds for any purpose whatsoever. *Cf. American Foundation Co*, 2 T.C. 502.‖ What was determined there was the propriety of a deduction. As said above, the allowance of the deduction did affect the basis of the bonds, nevertheless, we do not think the statutory language covers the inconsistent treatment of deductions affecting the basis of property.

For the reasons stated, section 3801 is not available to the respondent and his action in respect of 1945 is barred by the provisions of section 275(a) [§ 6501(a), 1954 Code].

Reviewed by the Court.

Decision will be entered for the petitioner.

TURNER, J., *dissenting:*

The facts, in my opinion, bring the instant case squarely within the provisions of section 3801 of the Internal Revenue Code. In subsection (b) thereof, it is provided that when a determination under the income tax laws determines the basis of property for gain or loss on a sale or exchange, and in respect of any transaction upon which such basis depends there was an erroneous omission from the gross income of the taxpayer and, on the date the determination becomes final, correction of the effect of the error is prevented by operation of internal revenue laws other than section 3801 and section 3761,** the effect of the error shall be

‡ Now § 1312(2). [Ed.]

§ Now, somewhat modified, § 1312(6). [Ed.]

‖ In the *American Foundation Co.* case, it was held that a determination that certain stock was received in a nontaxable exchange did not permit re-opening, under § 3801(b)(5), the years in which the stock was sold (when the taxpayer had claimed a stepped-up basis, on the theory the stock had been received in a taxable exchange). The Tax Court's position was that the determination of nontaxability "did not determine the basis of the shares for any purpose whatever." [Ed.]

** Now § 7122 (relating to compromises). [Ed.]

corrected by an adjustment made under section 3801, if there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made, which position is inconsistent with the erroneous omission. Under section 3801(c), it is provided that the adjustment authorized under subsection (b) shall be made in the same manner as if there were a deficiency with respect to the taxpayer, and as if on the date of the determination specified in subsection (b) one year remained before the expiration of the period of limitation upon assessment for such taxable year.

In keeping with the position maintained by the taxpayer, this Court, in the proceeding docketed at 14104, and pursuant to the pronouncements of the Supreme Court in *Commissioner* v. *Korell*, 339 U.S. 619, entered its decision for 1944, based on the allowance under section 125 [§ 171(a), 1954 Code] of the claimed deductions for amortization of the bond premiums paid on the purchase of the American Telephone & Telegraph Company and the Commonwealth Edison Company debentures. On the basis of this decision, it was thus apparent that the respondent, in making the refund for 1945, erroneously and contrary to the position which had been taken by the taxpayer, but in harmony with his own determination that the bond discount was not deductible for 1944, had omitted from 1945 income a part of the taxable gain realized by petitioner in that year on the sale of the said debentures. Following the Supreme Court, this Court in its decision for 1944 in the proceeding at Docket No. 14104, adopted the position which had been maintained by the taxpayer, which position was inconsistent with the position which had been taken by the respondent, which position of the respondent resulted in his erroneous omission from 1945 income of a part of the taxable gain realized by petitioner in that year on the sale of the debentures, all of which, in my opinion, brings the instant case within the provisions of section 3801 (b)(5) of the Code.

It is said in the Court's opinion herein, however, that, even so, the 1944 determination was a determination of a deduction from gross income, not a determination of petitioner's basis for the debentures for gain or loss on the sale or exchange thereof and, accordingly, section 3801(b)(5) is not applicable, since that section applies only if the determination was a determination of basis for the said debentures and that a determination that bond amortization is an allowable deduction in computing net income is not comprehended.

The conclusion, in my opinion, not only ignores the general scheme of the statute, but is contrary to specific provisions thereof. The general definition of basis of property for gain or loss purposes is cost. Section 113(a) [§ 1012, 1954 Code.] So far as appears, there can be no question that the bond premium was *de facto* a part of petitioner's cost of the debentures herein, and in the absence of some statutory adjusting requirement, would be a part of the taxpayer's basis therefor, under section 113(a). In providing for the deductions prescribed in section 125, however, Congress was not unaware of the logical impact of the deduction allowed on a taxpayer's basis, for gain or loss purposes, for the bonds. It accordingly made specific provisions in section 113(b)(1)(H),†† to the effect that the basis of debentures, in the circumstances here, shall be the basis determined under subsection (a), adjusted "to the extent of the deductions allowable pur-

†† Now § 1016(a)(5). [Ed.]

suant to section 125(a)(1) with respect thereto." The deductions determined and allowed by the decision in the proceeding at Docket No. 14104 were obviously deductions allowable pursuant to section 125(a)(1). It accordingly follows that the decision of this Court in that proceeding, to the effect that petitioner was entitled to the deduction under section 125, was by statutory fiat a determination of the taxpayer's basis for the said debentures, for gain or loss, on the subsequent sale or exchange thereof.

It is accordingly my view that the contrary conclusions expressed by this Court in its opinion herein are erroneous.

MURDOCK, J., *agrees with this dissent.*

Note

1. In a later case involving identical facts, the government advanced a third argument: that the determination that amortization was allowable in 1944 required "the exclusion from gross income" of an item with respect to which tax was paid within the meaning of § 1312(3)(A). The Tax Court found that "this novel contention" (that a deduction from gross income is equivalent to an exclusion) was "without merit." *Schulman* v. *Commissioner*, 21 T.C. 403 (1954). Even if the government's contention had been accepted, there would be the further problem of establishing that the item excluded in 1944 was "erroneously excluded or omitted from the gross income of the taxpayer" for 1945.

2. While §§ 1311–15 are largely derived from § 3801 of the 1939 Code, there were a number of changes in detail. Section 1312(6), in particular, is a substantial revision of old § 3801(b)(5), involved in the *Brennan* case. Would the revised provision permit the adjustment claimed by the government?

3. When § 1311 is applicable, an adjustment for the year of error is authorized by § 1314 in the amount of "the increase or decrease in tax previously determined [for the year of error] which results *solely* from the correct" treatment of the item in question. *I.e.*, the year of error is not re-opened for the purpose of correcting unrelated errors, although items like the medical expense and charitable contribution deductions may have to be recalculated. The amount thus determined, with interest, is either refunded to the taxpayer or assessed and collected as a deficiency, as the case may be. As a result of a 1954 amendment, if the adjustment for the year of error creates, increases, or reduces an operating loss or capital loss for that year, other years to which the loss is carried over may also be adjusted. No adjustment can be made for a taxable year before 1932.

Note that it may be better, for either the taxpayer or the government, to allow sleeping dogs to lie. In *Gooch Milling and Elevator Co.* v. *United States*, 78 F. Supp. 94 (Ct. Cl. 1948), for example, the taxpayer recovered $7,935.58, with interest, under § 3801 for the fiscal year ending June 30, 1935, because the government determined a deficiency of $6,663.42 for the year ending June 30, 1936. If the deficiency had not been determined for 1936, the taxpayer could not have obtained a correction for 1935 because the statutory period for claiming a refund had expired. Conversely, the taxpayer who erroneously omitted property received as compensation from his income for the year of its receipt may be better off to employ a zero basis on a later sale of the property, since if he insists on its proper basis (thus reducing his capital gain in the year of sale), the government may be entitled under § 1311 to recover a tax, with interest, on ordinary income for the earlier year. Note also that action by or affecting one taxpayer may open the door to an adjustment in respect of a related taxpayer. A common situation is a deficiency against the grantor of a trust under the *Clifford* doctrine; if the deficiency is upheld, a refund to the trustee or to beneficiaries may be in order.

4. When there has been an omission of income in a barred year, can the Commissioner arbitrarily assign the amount in question to any open year he chooses and insist on an

adjustment under § 1311 if the taxpayer resists? Conversely, can a taxpayer who failed to take a deduction in a barred year simply take the same deduction in any open year and resort to § 1311 if the Commissioner disallows the improper deduction?

5. If the stock in *Bennet* v. *Helvering, supra,* p.761, had been *sold* at a loss, the government would have been allowed to proceed under § 1311 (unless the time limit of § 1314(d) was applicable) to collect a tax for the year the stock was received. See § 1312(6). Would a similar adjustment be allowed by § 1312(6) where the stock was not sold, but became worthless, as in the case itself? See Senate Report, p. 448.

As the Second Circuit pointed out in the *Bennet* case, some courts apply the doctrine of estoppel to deny a loss on property erroneously omitted from income when received. But if the government can open the earlier year by way of an adjustment under § 1311, is there any justification for estopping the taxpayer?

6. See Holland, "Tax Consequences of Inconsistent Positions—A Review of Section 3801," *10th Annual N.Y.U. Inst. on Fed. Taxation* 807 (1952); Maguire, Surrey, and Traynor, "Section 820 of the Revenue Act of 1938," 48 *Yale L.J.* 509, 719 (1939); Wilkinson, "Mitigation of Effect of Statute of Limitations under the Income Tax Laws," 27 *Tex. L. Rev.* 818 (1949).

For an exhaustive study of estoppel, recoupment, and § 3801, see Mintz and Plumb, "Taxing Income in Years Not Realized under Doctrine of Equitable Estoppel," 1954 *So. Calif. Tax Inst.* 481.

7. If the taxpayer in the *Brennan* case had paid the deficiency determined for 1944 and sued for a refund, could the government have set off the 1945 deficiency by way of equitable recoupment if 1945 was a barred year? *Wood* v. *United States,* — F.2d — (2d Cir. 1954); but *cf. McEachern* v. *Rose, supra,* p. 766.

8. Note that estoppel, recoupment, and § 1311 will never come into play unless a transaction or other event in one year is related to an error that occurred in another year. Many erroneous omissions, inclusions, and deductions will go entirely uncorrected, once the statute of limitations has run, because no later transaction will afford any basis for a claim of estoppel or recoupment or for an adjustment under § 1311. Is there any reason why an erroneous deduction followed by a deduction of the same item in the proper year should be treated differently from an erroneous deduction standing alone? Or why an erroneous inclusion followed by a proper inclusion of the same item should lead to a correction that would not be permissible if the erroneous inclusion had no later counterpart?

Section D. Indirect Methods of Computing Income

BECHELLI v. HOFFERBERT

U. S. District Court, Maryland, 1953
111 F. Supp. 631

CHESNUT, District Judge.

These two cases were tried together as they involved mainly similar questions. The plaintiffs in both suits are suing the Collector of Internal Revenue for alleged overpayment of personal income taxes for the years 1943, 1944 and 1945. After the plaintiffs had duly filed their income tax returns for the respective years the Commissioner of Internal Revenue in due course assessed deficiencies against each of the taxpayers for the respective years including a 5% penalty for alleged lack of due care in preserving bookkeeping records, and interest. . . .

The plaintiffs Bechelli and Giangrandi are naturalized citizens of former Italian nationality who have been engaged as partners in the business of conducting a comparatively small bar and restaurant in Baltimore City at or near 8 E. Preston

Street, since 1934. Prior to 1943 they had filed partnership income information tax returns for many years and continued to do so in the same general way for the tax years in question. They also filed their individual income tax returns jointly with their respective wives. No objection or criticism has been made by the Commissioner with respect to the correctness as to the net income shown by these returns except with regard to the item of income from the partnership. They were partners entitled to an equal division of the profits. The Commissioner determined that the partnership income had been understated for the three years in question respectively as follows:

For the year 1943	$5,130.02
For the year 1944	9,417.62
For the year 1945	764.37

Accordingly he determined deficiency assessments against Giangrandi and wife for understated income in the following amounts:

For the year 1943	$1,488.14
For the year 1944	920.31
For the year 1945	123.78

For Bechelli and wife the income deficiency was stated to be:

For the year 1943	$1,830.11
For the year 1944	1,868.67
For the year 1945	141.40

In all cases the Commissioner added a 5% penalty and interest. In considering the weight and effect of the evidence I accept the now well established rule in such cases that there is a presumption in favor of the correctness of the Commissioner's determination and the burden of proof, by a preponderance of the evidence, is on the taxpayers to show the contrary.

The principal contention of counsel for the defendant Collector is that the bookkeeping records of the partnership were inadequate and insufficient to enable the Commissioner to determine the correct partnership income.[1]

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[1] Reference is made to section 54(a) of the Internal Revenue Code, which provides in material part

"Every person liable to any tax imposed by this chapter . . . shall keep such records . . as the Commissioner . . . may . . . prescribe."

Section 39.54–1, Treasury Regulations 118 states

"Every person subject to the tax . . . shall for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1 . . . ."

Section 41 of the Internal Revenue Code provides:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ."

Section 39.41–1 of Treasury Regulations 118 provides:

"*Computation of net income:* . . . If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

[The corresponding sections of the 1954 Code are § 6001 (records) and §§ 446(a) and (b) (accounting methods). Ed.]

After hearing all the evidence in this case, including the testimony of Bechelli and Giangrandi and of their bookkeeper or accountant, and an examination of the exhibits in the case, including the partnership books, I conclude that the records of the partnership business as so kept were adequate as a matter of law and were reasonably and substantially correct in view of the nature of the business.

Bechelli and Giangrandi are not very literate or well educated persons but their bookkeeping was done for them by a Mr. Owens, a thoroughly credible witness, not an expert accountant but nevertheless familiar with proper bookkeeping methods from long experience as a clerk to the Deputy Comptroller of the B. and O. Railroad Company. He was a very long time and close friend of the partners and performed the service for them without pecuniary compensation, but was frequently at their place of business. The method of keeping the books was this. At the end of each day Giangrandi (or at times his chief employee in the business) prepared a written itemized statement showing the cash receipts of the day as taken from the tape on the cash register and an itemized statement of the expenses paid for the day for supplies for the bar or kitchen. This daily account of receipts and expenditures was given to Mr. Owens every two or three days and taken home by him and entered in the books for each day, at the end of the month for his own convenience. The daily sheets were not preserved but the receipts for the day and the expenses of the business, the latter separately classified, were recorded in permanent books which were offered in evidence. These books show that such an entry was made for each day of the month. Originally the daily receipts from the bar and from the kitchen were not separated but during the war years, when food rationing was in force, the bar receipts were entered separately from the kitchen receipts. The expenses were classified and separately entered for each day under different headings such as

bar expense, kitchen expense, salaries, miscellaneous supplies, laundry, rent, electricity and telephone, advertising and donations, fixtures and repairs, taxes, license fees, watchman service, miscellaneous.

The testimony of the witnesses satisfied me that the bookkeeping was honestly and fairly done and that the figures entered in the books for gross income and expenses were substantially correct. The critical test as to the sufficiency of the books on their face is whether they are sufficient to calculate the net income. If they are sufficient in this respect then the simpler the books the better. There is no prescribed detail as to just what books or how many must be kept. The question in each case must be determined on its particular facts and in view of the nature, volume and complexity of the business. Here the books as kept do show day by day receipts and expenses. If the figures are correct the books are sufficient to show the net income. Of course the books on their face are not conclusive of the proper figures and their inaccuracy, whether by inadvertence or fraud, can be shown by other evidence. In this case there is no such other evidence; nor is there any evidence even of reasonable suspicion as to the fairness and accuracy of the books as kept. It appears from the evidence of the Internal Revenue Agent who was instructed to examine the books and prepare his report to the Commissioner, that the particular investigation was based primarily on an anonymous letter suggesting that one of the partners, Giangrandi, had recently been buying a sub-

stantial amount of government bonds. When this was suggested to Giangrandi he at once without hesitation and with entire voluntary cooperation with the agent took him to his safe deposit box and showed all the investments that he had which the agent was frankly candid in saying were purchases well within the taxpayer's income. Nor is there any evidence of any other increase in net worth of either of the taxpayers. Both are men of comparatively modest property holdings consisting principally, as to Bechelli, of the ownership of the building in which the restaurant is conducted on the lower floors and, as to Giangrandi, his principal holdings consist of his dwelling and a few thousand dollars of bonds or stock accumulated by the partners respectively during their nearly twenty years of business activity. Nor is there any evidence tending to show large or unusual expenditures on their part. Still further their testimony as witnesses subject to examination and cross-examination very affirmatively tends to indicate that their business and their business records were honestly conducted and kept. They both seemed to me to be entirely credible witnesses.

The chief contention of government counsel as to the alleged inadequacy of the records is that the partnership did not preserve the daily cash register receipts or table checks to support the figures in the books after the entries had been made in the permanent book. Thus it is said that the books consisted only of a cash book and invoices. But in addition thereto the partnership did keep a bank account which was made available to and examined by the revenue agent. No criticism is based on it nor on the sufficiency or accuracy of the invoices for goods purchased. As the larger part of the purchases for the business consisted of whiskey, wine and beer for the bar there were, by virtue of various governmental regulations, records of all such purchases and there is no criticism of the accuracy or completeness of the invoices or expenditures for food and liquor.

Counsel for the parties have cited a number of cases tending to support their respective contentions with regard to the adequacy of the partnership books but both freely admit that none are of themselves controlling precedents in view of the particularities of the case. I think it unnecessary to extend this opinion by reference to the facts of these cited cases except to say that many of them have been examined and most are not really even closely parallel on the facts to the instant case, with the exception that a few cases in the Tax Court may be thought to present not very different factual situations where the books were found adequate under the special facts. *Ward* v. *Commissioner*, 1948, 7 T.C.M. 505; *Miller* v. *Commissioner*, 1951, 10 T.C.M. 33; *Shinkonis* v. *Commissioner*, 1951, 10 T.C.M. 503.

As the partnership books have been found adequate for the determination of the partnership income it seems unnecessary to discuss in detail the basis for the Commissioner's restatement of income. I will, however, refer to it briefly because I think its analysis will, on comparison with the evidence in the case, show that it is here quite inapplicable. The re-computation of the partnership income as made by the Commissioner has been filed as an exhibit to the complaint in each of the cases as Plaintiff's Exhibit No. A7, and has been further explained in the rather extended oral testimony of the Revenue Agent, Mr. Brown. It will be noted that the gross receipts of the partnership by the books were:

1942	$80,937
1943	109,375
1944	95,233
1945	105,366

(the odd cents in each case eliminated)

It will also be noted that the Commissioner's figures as a result of the restatement of the income shows an understatement of sales of—

1943	$5,130
1944	9,417
1945	764

It also appeared from the evidence of the Agent that he has accepted without question the expenses of the business consisting of labor, supplies and food and he also did not question the accuracy of the cash receipts as reported in the books for food; or, in other words, the items in the book for receipts from the kitchen. The only item which he questioned and undertook to revise was the receipts from the bar. These consisted of the sales of whiskey, wine and beer. The receipts from these three sources or bar revenues were not segregated in the books and I know of no requirement that they should have been. It was the theory of the Agent that the partnership must have made larger profits on the sale of whiskey than the books apparently indicated from the bar receipts. What the agent undertook to do, therefore, was to determine what percentage of the total bar receipts was attributable to the sale of whiskey. It is not contended that this percentage could be determined with real accuracy but the Agent estimated that 64.3% of the bar receipts were for whiskey. He reached this percentage by a comparison of the purchase invoices for all liquor in 1944 which he said showed that 64.3% of all liquor purchased was whiskey. He then assumed without further computation that the same percentage of whiskey was purchased for the bar in 1943 and 1945. And he further assumed that the percentage of whiskey sold at the bar should be the same as the percentage of all liquors bought for the bar in the one year. Having thus estimated the percentages of whiskey, wine and beer sold, he made a further division between whiskey sold in the package (by the bottle or case) and the amount of whiskey sold at the bar by the glass or drink. His computation then proceeded to estimate the gross profit that *should* have been received from the individual sales of the several classes of liquor by applying to each sale a so-called "mark-up" of sale price over cost price. For this mark-up price he assumed, based on information received from a circular issued by Seagram Distillers, that bar whiskey, that is whiskey sold by the drink served over the bar to an individual customer, should be marked up 144%. He further assumed the bottled whiskey should be marked up 26% and that beer should be marked up 100%, while wine and food should not be marked up over cost price at all.

Counsel for the plaintiffs dispute the propriety of the mark-up practice both as to the amount and as to principle. I am satisfied, however, that where the taxpayer engaged in merchandising does not keep books which if true show the receipts from sales, there is good judicial authority to apply a proper percentage of mark-up for sale price over cost price. The percentage, of course, will vary with the particular business. *Gamm* v. *Commissioner*, 5 Cir., 39 F.2d 73; *Harvey* v. *Early*, 4 Cir., 189 F.2d 169; and numerous other cases in the Tax Court. But while the use of mark-up is correct in principle in particular cases, I am satisfied that the

evidence in this case makes it inapplicable both in principle and in fact, and the figures that are ultimately obtained thereby are based on analyses and assumptions which are contrary to the actualities of the case as disclosed by the evidence. In the first place, it is not at all clear to me that the Agent's percentage figure of 64.3% for whiskey sold is a reliable figure even as a reasonably approximate estimate. Again it seems to have been the assumption that all the whiskey used at or in connection with the bar was paid for at certain minimum prices of not less than 35¢ per drink of a certain quantity. The evidence as to the activities of the business show that the Agent's estimates as to price and quantity were less than he figured. For instance, the evidence of the bartender was that many drinks were sold for 25¢ and not for 35¢ per established quantity and that for much of the time the quantity per drink was more than that estimated by the agent. Again the Agent assumed that beer was sold at 20¢ per glass while the testimony shows that it was sold at 15¢ per glass. Still further evidence was that during the war years the quality of employees for service was poor and there was much incidental loss in spillage, breakage and pilferage. It thus seems clear enough that the basis for revision of the partnership income as made by the Commissioner in this case is far more complex than the simple application of a mark-up of sale price over cost price to determine receipts where quantities of the goods sold are known but the books do not correctly show the actual receipts. In the instant case the revision made is more highly complex in that to determine the quantity sold requires a very detailed analysis of figures based on various assumptions and resulting in estimates only and is applied not to actual known gross quantities sold but only to one kind of one class of liquors sold. Counsel have not referred me to any case which seemingly justifies a revision of this complex character.

I conclude, therefore, both on the law and the facts that the partnership returns were adequate, sufficient and accurate....

The Commissioner imposed a 5% penalty* [§ 6653(a)] for the taxpayers' carelessness in bookkeeping records. It will be noted that this was not a fraud penalty and the government has not charged fraud at all in this case. Counsel for the government states that the 5% penalty was imposed for the failure to preserve inventories in sufficient detail and also because there were no capital or income accounts between the partners themselves. It is not contended that in fact either partner overdrew his half share of the profits. The failure to preserve supporting data such as table checks or particular bar receipts, if any were given, was naturally a matter of dissatisfaction to an expert accountant and it is obvious that if more care had been taken in this respect very probably these suits would have been avoided. I do not think the Commissioner acted arbitrarily or capriciously in imposing the 5% penalty for the reason stated. I have concluded that his action in this respect should not be disturbed....

GARIEPY v. UNITED STATES

U. S. Court of Appeals, Sixth Circuit, 1951
189 F.2d 459

Before HICKS, Chief Judge, and SIMONS and ALLEN, Circuit Judges.

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* The penalty is 5 percent of the "underpayment." See § 6653(a); and *cf.* § 293(a) of the 1939 Code. The opinion does not explain how a penalty can be imposed if there was no deficiency.

SIMONS, Circuit Judge.

The appellant on a two count indictment was convicted of violating § 145(b) [§ 7201, 1954 Code], in that he wilfully and knowingly, with intent to defeat and evade a large part of the income tax due and owing by him to the United States, filed and caused to be filed with the Collector of Internal Revenue false and fraudulent returns. He was sentenced on both counts, the sentences were made concurrent, and he challenges the judgment upon numerous grounds. . . .

The returns charged by the government with falsely and fraudulently understating the appellant's income, are those filed for the tax years 1944 and 1945. In '44 the appellant reported a taxable income of $8,057.82, and in '45 a taxable income of $4,350.69. When investigation was begun by agents of the Treasury, they were unable to find adequate records disclosing receipts of income by the appellant. The investigators then undertook to establish his income by the so-called "net worth" method. This involved fixing a base from which increases in the taxpayer's assets could be estimated by examination of bank accounts, real estate records, showing investments, the books of stockbrokers indicating purchase of securities, and so on. This method of determining the liability of a taxpayer (either civil or criminal) is an established practice of the government and has received the sanction of courts in many cases. It is now too late for a taxpayer who fails to keep or preserve records to complain. To be dependable, however, the method requires a starting point, reasonably well established as accurate.

The investigators in the present case began their inquiry into the appellant's asset situation with the year 1938, the first year in which he had filed a tax return. He reported income in that year of $3,156.90. Reviewing his activities prior to that year, their inquiry disclosed that the appellant had graduated from the University of Michigan in the year 1934; that from then until June, 1935, he was an interne at Providence Hospital receiving a compensation of $20 per month in addition to room and board; that for the next year until June, 1936, he was at the University of Minnesota Hospital where he received his room and board but no money, that from 1936 to 1937 he was at the John Seeley Hospital of the University of Texas, where he likewise received no money. He began the practice of his profession at Royal Oak, Michigan, shortly after finishing his Texas internship. While attending medical school his brother, Louis, a surgeon and physician, loaned him between $3,500 and $4,000, which was repaid in small amounts over the period 1937 to 1941. When the appellant came to Royal Oak he lived for a year and a half with his brother Edward, who loaned him $2,000 in 1937, and later other sums, so that by 1943 he owed him somewhere between $5,500 and $6,000. This brother took title to real estate purchased by the appellant, as security for loans, and they were not fully paid off until 1944. All of these facts were either stipulated or presented to the jury by uncontroverted evidence. From them the Treasury agents deduced that at the end of 1937 or the beginning of 1938, the appellant had no assets but was in debt in the amount of $4,858.64, and that at the end of 1938, during which he had a net worth increase of $4,525.70, the net worth of his assets was $332.94 less than zero. Thus was established by substantial evidence, a base for computation of net worth increases. It is not destroyed by argumentative speculations not supported by evidence, that the appellant may have had other substantial assets.

From 1938 on, according to the computations of the Treasury agents, the appellant's practice materially increased, as did the net worth of his assets. In an exhibit reflecting their computations and indicating the reported income and net worth increases, the table shows a net worth at the end of the tax year 1945, of $128,938.52. It is here reproduced and set forth in the margin.[1]

The transactions upon which this computation was made are all sustained by evidence. They were not successfully controverted. It is true that appellant's counsel made vigorous attacks upon the accuracy of the computation. At best it was, of course, but an estimate, but as an estimate it was entitled to the consideration of the jury because based on substantially the entire evidence in the record. *United States* v. *Johnson*, 319 U.S. 503, 519, 63 S. Ct. 1233, 87 L. Ed. 1546; *Bell* v. *United States*, 4 Cir., 185 F.2d 302. The principal attack of the appellant upon the evidence which sustains this computation is two-fold. The first is the challenge to the accuracy of the appellant's net worth, or lack of it, at the base period, and secondly is the contention that each item of evidence must be so fully and accurately established that it permits no reasonable doubt as to the fact upon which reliance is placed. As to the first contention, all of the evidence, and that includes testimony of reluctant witnesses permitted to be cross-examined as hostile, points with great persuasiveness, if not indeed conclusively, that when the appellant began his professional practice in 1937 he was without assets and heavily in debt. As to the second, the appellant appears to confuse the function of the court with that of the jury. In *United States* v. *Valenti*, 2 Cir., 134 F.2d 362, 364 certiorari denied 319 U.S. 761, 63 S. Ct. 1317, 87 L. Ed. 1712, Judge Clark made a careful study of the applicable rule, and we accept fully his conclusions. "The requirement of proof beyond a reasonable doubt is a direction to the jury, not a rule of evidence; it operates on the whole case, and not on separate bits of evidence each of which need not be so proven; and it cannot be accorded a quantitative value other than as a general cautionary admonition (citing cases). It is the court's function to decide whether evidence is competent to justify certain inferences; it is not the court's function to decide which of various inferences should be drawn."

The appellant's reliance upon *Bryan* v. *United States*, 5 Cir., 175 F.2d 223 and *United States* v. *Fenwick*, 7 Cir., 177 F.2d 488 is of little avail to him because there was no such comprehensive investigation either as to the net assets at the base period or subsequent increases as was here undertaken. Moreover, in the *Bryan* case, a vigorous dissent weakens the conclusion there arrived at, and the *Fenwick* case appears to be in conflict with *United States* v. *Hornstein*, 7 Cir., 176 F.2d 217, decided by the Seventh Circuit but a few months prior to *Fenwick*. Judge Miller

[1]

Year	Taxes Paid	Income Reported	Net Worth Increases	Net Worth
1937		.		(4,858 64)
1938	14.28	3,156 90	4,525.70	(332.94)
1939	28.82	3,948.76	5,171.89	4,838.95
1940	220.17	7,238 74	5,590 01	10,428.96
1941	248.94	4,412 25	22,891.05	33,320 01
1942	1,182.76	7,109.30	18,286 74	51,606.75
1943	1,417.10	5,313.74	(2,778.21)	48,828 54
1944	1,904.08	8,057 82	20,166.21	68,994.75
1945	812.67	4,350.69	59,943.77	128,938 52
	$5,828.82	$43,588.20	$133,797.16	

of this court, writing in *Brodella* v. *United States*, 6 Cir., 184 F.2d 823, had no difficulty in distinguishing the *Bryan* and *Fenwick* cases from cases involving facts similar to those here produced.

The defensive strategy of the appellant was to remain silent and challenge the government to prove its case. This, of course, he had a right to do but he now urges, upon appeal, that the government had an obligation to establish beyond reasonable doubt that there were no resources other than current taxable income with which to make the substantial expenditures of the prosecution years. In other words, his counsel asserts that he may have had a legitimate "nest egg," accumulated in previous years, with which to make such investments, and, impliedly, out of unexplained but untaxable income. The argument borders on the fantastic. If there were such sizable "nest egg" some proof would certainly have been available other than the testimony of the defendant himself. While the government is not required to prove a negative or to refute all possible speculation as to the source of the appellant's asserted funds, *Rossi* v. *United States*, 289 U.S. 89, 91, 53 S. Ct. 532, 77 L. Ed. 1051; *Jelaza* v. *United States*, 4 Cir., 179 F.2d 202; *United States* v. *Hornstein*, *supra*: *Bradford* v. *United States*, 5 Cir., 130 F.2d 630, it went far beyond its reasonable obligation in that respect. During most of the pre-prosecution years the appellant was substantially indebted to his brothers and to his divorced wife for the balance of an alimony settlement. His income tax returns from 1938 to 1943 inclusive, showed no such income, taxable or untaxable, to warrant the inference that such "nest egg" had been created and maintained. The jury was warranted in assuming that none existed, or if created by withholding of income from prior or current tax returns, it established a course of concealment and tax evasion. If this evidence stood alone it would have supported the jury's verdict.

But there was more,—much more, to establish not only evasion but wilfulness as its inescapable characteristic. When the investigation by Treasury agents disclosed that the estimated increases in the appellant's net worth would lead to the inference that he had failed to disclose in his returns approximately $90,000 of income, the appellant undertook to explain that he had received $50,000 in 1942 as a gift from a prominent citizen of Royal Oak, Michigan, and that this was untaxable. There were five different versions at five different times, of the reasons why the gift was made, including the explanation that the giver had been taking liberties with the appellant's wife.* To the investigators he repeatedly refused to disclose the name of the donor, but to the accountant who had worked on the appellant's tax returns and who had also assisted the agents in their investigation, he did disclose the alleged source of the gift. This made it possible for the government to completely shatter an expected defense along this line. Its evidence in this respect was vigorously challenged at the trial and is assailed here. It is urged that it consists of extra-judicial admissions, was therefore inadmissible and may not support a verdict of guilt. The rule applies, however, only to extra-judicial admissions when they stand alone, unsupported by other evidence. Here they but reinforce the permissible inferences to be drawn from the evidence submitted at the trial.

* See *Gariepy* v. *Pearson*, 207 F.2d 15 (D.C. Cir. 1953). [Ed.]

There was evidence of the destruction of pertinent books and records, and of the defendant's habit of dealing in large amounts of cash. He had at his home several vaults and a number of safes in one of which more than $22,000 in currency was kept when the special agent visited the appellant's home in 1946. He paid $41,000 upon two occasions in 1945, to a broker's agent for the payment of stocks. These payments were in cash, mostly in currency of small denominations, transferred in the bedroom of his brother's house, wrapped in a newspaper or a paper bag. The evidence of deliberate and wilful evasion seems to us overwhelming.

The accountant's testimony was not privileged. There is no evidence to show that the accountant, at the time he received and relayed the information to the investigators, was in the employ of counsel for the appellant, but even if so there is respectable authority that denies him the privilege status. *Himmelfarb* v. *United States*, 9 Cir., 175 F.2d 924; 8 Wigmore on *Evidence*, (3rd Ed. § 2325.) . . .

The judgment is affirmed.

UNITED STATES v. CASERTA

U. S. Court of Appeals, Third Circuit, 1952
199 F.2d 905

Before MARIS, GOODRICH and STALEY, Circuit Judges.

GOODRICH, Circuit Judge.

This is an appeal from a conviction for income tax evasion under I.R.C. 145(b).

The prosecution was confronted here with a situation not unusual in income tax prosecutions. If the taxpayer had done what he was legally required to do, keep a record of his income and expenditures, the case would be comparatively easy. The question then would be the accuracy of the records kept. The taxpayer here involved kept no records. How is his violation of income tax obligation to be proved? In the effort to ascertain a non-bookkeeping taxpayer's liability, many cases have discussed the requirements which must be met on the so-called net worth theory. This theory is in effect that if a taxpayer's net worth has increased during a given period in an amount greater than his reported income for that period, there must be a discrepancy in his income tax return and payment.

An outgrowth of this net worth method is the "expenditure" test involved in this case. The theory of it is simple, though its application may become difficult. It starts with an appraisal of the taxpayer's net worth situation at the beginning of a period. He may have much or he may have nothing. If, during that period, his expenditures have exceeded the amount he has returned as income and his net worth at the end of the period is the same as it was at the beginning (or any difference accounted for), then it may be concluded that his income tax return shows less income than he has in fact received. Of course it is necessary, so far as possible, to negative nontaxable receipts by the taxpayer during the period in question. The cases show, however, a rather surprising rule that when the discrepancy between increased net worth and reported income is shown, the burden of explanation shifts to the taxpayer, at the same time repeating the usual criminal law rule that the burden throughout a criminal case is upon the prosecution. We do not, however, get into this particular ramification in the case under discussion,

for the prosecutor offered proof negativing receipts for [from] nontaxable sources such as gifts, inheritance and so on.[1]

The expenditure method of proof of income received judicial approval in *United States* v. *Johnson*, 1943, 319 U.S. 503, 517, 63 S. Ct. 1233, 87 L. Ed. 1546. We think that with this case as a foundation some of the vacillation apparent in Courts of Appeals opinions with regard to proof in tax evasion cases should now be disregarded.

What constitutes expenditure? The natural answer is: What a man spends, of course. How does one show expenditures? If a man has a bank account and puts everything he receives into the account, his expenditures are pretty well shown by what he spends it for in checking it out. But suppose he withdraws from his bank account a sum in cash, a check made payable to himself or an impersonal payee. Does that show expenditure? It may well do so if we proceed on the ordinary assumption that people do not draw money from bank accounts unless they are going to spend the money for something. On the other hand, suppose a man writes a check to "cash" for $500. and the same day buys an overcoat for $100. and a suit of clothes for the same amount. Now what do we charge him with, an expenditure of $700.? If cash withdrawals from a bank account are to be treated as cash receipts to a person, surely it is incorrect to charge individual items for which he has paid cash to his list of expenditures unless it is shown that the cash bank withdrawals had nothing to do with the individual items. Otherwise, a man doubles his taxable income when he writes a check for "cash" and spends the money he gets from his bank. This would be a very happy way of increasing one's income if it could be done.

All of this seems so obvious that we have had difficulty in believing that the government's case proceeded on a different theory here. But the record does show that this defendant was charged, in the evidence tending to show what his income was, with both cash withdrawals and cash purchases. It was not shown that the cash withdrawals did not go for cash purchases.[2] Furthermore, it is denied, even on appeal, that this was an incorrect method.

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[1] The prosecution introduced evidence that the defendant had never filed an income tax return prior to 1945, and that he told the investigating tax agent that he borrowed no money prior to 1944, held no money belonging to others, and received no gifts or inheritance of any kind. Evidence was also introduced to show that defendant claimed his wife and mother-in-law as dependents, and that they contributed nothing to defendant's available resources.

[2] In computing the defendant's taxable income the government included the face amounts of checks drawn to "cash" totalling $2850 during 1948, and $742.60 during 1949. It also included cash payments of $1900 for a boat, $300 to the Clerk of Court, $783.10 to General Motors, $1319.98 to the Powell-Gardner Buick Co., and many others. The investigating revenue agent testified that in cases where he had been able to trace the proceeds of a check drawn to "cash" into an identifiable cash purchase, the resulting duplication was eliminated. Where tracing proved impossible, however, and where an analysis of the respective dates and amounts of the checks and cash purchases showed no discernable pattern, duplication was assumed not to exist and both checks and purchases were included. The following are excerpts from the trial transcript:

"Q. (by defense counsel on cross-examination). Can you state for a fact that Mr. Caserta did not use any of these cash withdrawals in payment of the cash expenditures . . . for the years 1946, 1947, 1948, and 1949, wherever they occur? A. (by the investigating revenue agent). No, sir, I cannot state that as a fact.

"Q. In your tax assessment or analysis, then, you did not credit the cash withdrawals against the cash expenditures; is that correct? A. No, sir.

The trial judge told the jury that they must not duplicate items. We do not think this is enough in the case at bar in view of the testimony just quoted.

What has just been said demonstrates such fundamental error that defendant is entitled to a new trial....

Note

1. The government of course has the burden of proving guilt beyond a reasonable doubt in a criminal case, and by virtue of § 7454(a) it also has the burden of proving fraud in a civil case when the 50 per cent penalty for fraud is assessed. *Infra,* p. 871. If the government's only evidence of opening net worth for a given year consisted of a showing that the taxpayer could have accumulated little or no property if his tax returns for earlier years were honest, would its burden be met? In the recent tax fraud prosecution of Frank Costello, the government introduced into evidence a sworn statement as of October, 1937, in which the defendant asserted that his net worth was then some $30,000. *New York Times,* Apr. 8, 1954, p. 31. If the defendant's tax return for 1937 reported $70,000 of income, would the government be justified in assuming that net worth as of January 1, 1938 was not more than $30,000 plus an appropriate fraction of $70,000 (on the assumption that his income was earned equally over the entire year); or would it be necessary in a criminal prosecution to assume that the opening net worth for 1938 was $100,000 (less expenses shown for the latter months of 1937)? An increase in assets during a prosecution period might have been financed by loans to the taxpayer or by gifts, bequests, and other non-taxable sources of funds. Must the taxpayer prove that he had such sources of income, or must the government negate them?

In *Bryan* v. *United States,* 175 F.2d 223 (5th Cir. 1949), the opening net worth as calculated by the government's auditor included a small bank account but no other cash on hand. On being asked whether the defendant might have had other funds, the auditor testified that, finding no record of any other funds, he assumed, though he did not know, that there were no others. The court reversed a conviction, saying:

> The evidence, being circumstantial, must exclude every reasonable hypothesis other than the guilt of the Defendant. The jury no doubt disbelieved, and had the right to disbelieve, Mrs. Bryan's testimony,* but in view of the auditor's admissions that he was not able to say that his computation included all of the assets of the Defendant at the beginning of the period, together with the absence of any admissions, records, financial statements, bookkeeping entries, or other findings, or evidence, tending to bind the Defendant as to the lack of additional assets at the beginning of the tax period, the evidence, in the light of the bill of particulars [limiting the government's case to allegations of understated gross business receipts, rather than fraudulent deductions], was insufficient to make out a prima facie case against the Defendant on the net worth-expenditure basis, and the case should not have been submitted to the jury since it did not exclude the hypothesis that the funds used in making some of the expenditures might have been from sources other than current business income. (175 F.2d at 227.)

A dissenting judge said

"Q. Were you able to relate or trace these cash withdrawals to any other cash expenditure not listed by you? A. If I didn't list it, Mr. Kossman, I guess I couldn't have traced it to that."...

"Q. Now, in determining his income for the year 1947 did you add the cash payment of $50 fine that he had made, and other cash items, $226.50, $29 75 for his wife, $10. to the church, and I think that is all—$306.27. Did you add that to the $4800 [checks drawn to cash] in order to arrive at his expenditures, is that correct? A. (by another internal revenue agent). That is correct."

* The defendant's wife testified that he had large sums on hand at the beginning of the prosecution period in a safe deposit box and that she made withdrawals during the period to cover certain large expenditures. [Ed.]

> The ultimate effect of the decision is to shackle the government to a practically insurmountable burden of proof in net worth-expenditure cases concerning matters which are peculiarly within only an evading defendant's knowledge. . . Each of the above methods [analysis of bank deposits, of net worth increase, and of expenditures] is predicated upon the sound legal proposition that evidence of a large amount of unexplained funds or property in the hands of a defendant during the tax years under scrutiny establishes a prima facie case of understatement of income during that period. . . . It is then incumbent upon the defendant to go forward and offer proof in explanation of this unreported excess income, much in the same manner as would be required under the "possession of recently stolen goods" rule. (175 F.2d at 227.)

Note the reference to the *Bryan* case in the *Gariepy* case, *supra.*

See Rothwacks, "Indirect Proof of Income," in American Bar Association, Section of Taxation, *Symposium on Procedure in Tax Fraud Cases* (1951) pp. 47–88; Avakian, "The Net Worth Method of Establishing Fraud," *11th Annual N.Y.U. Inst. on Fed. Taxation* 707 (1953); Krasilovsky and Stein, "An Evaluation of Net Worth Prosecution of Federal Income Tax Evaders," 7 *Okla L. Rev.* 49 (1954).

Although civil fraud and criminal cases have produced much of the litigation concerning indirect proof of income, these methods are also often employed to determine income in non-fraud deficiency cases, where the Commissioner's determination of a deficiency is presumptively correct, so that the taxpayer must carry the burden of proof. See Gordon, "The Use of Net Worth as a Basis for Civil Liability," *11th Annual N Y.U. Inst. on Fed. Taxation* 799 (1953). Use of these methods is not confined to big operators; in *Stuart* v. *Commissioner*, ¶ 51,279 P-H Memo TC, involving a dispute over $282 in tax, one of the issues was whether the taxpayer paid $23 for newspapers (5 cents daily; 15 cents on Sunday) or read a borrowed newspaper.

2. When OPA price ceilings were in effect, some business men paid over-ceiling prices and sold the goods thus obtained at prices that were also above ceiling Sometimes only the legal prices were recorded in the taxpayer's books of account, both on the receipts and on the disbursements side, and these figures were used in preparing the tax return. If the government proved that such a taxpayer received unrecorded income by selling goods at above the legal prices, would the taxpayer have the burden in a fraud case of proving that he *paid* more than was claimed on the returns for the goods sold—*i.e.*, could the government rest its case on proof of unrecorded income and on the assumption that the taxpayer was entitled to no deductions other than those claimed in the returns? See *Pleason* v. *Commissioner*, 22 T.C. No. 48 (1954).

In *United States* v. *Stayback*, — F.2d — (3d Cir. 1954), the court affirmed a criminal conviction of a taxpayer engaged in the manufacture and sale of metal products. His return for 1944 listed gross receipts of $4,000, cost of goods sold and other deductions of about $2,500, and net income of about $1,500. The government proved that approximately $55,000 of gross receipts was omitted, but did not allow any increase in cost of goods sold or other deductions because it was unable to calculate them. The court said.

> It is well settled that once the government establishes unreported income of the defendant and allows deductions claimed by him in his tax return and others that it can calculate without his assistance, the burden is on the defendant to prove that he had other allowable deductions which were not shown in his return.

See also *Clark* v. *U.S.*, 211 F.2d 100 (8th Cir. 1954). In a criminal case, the government does not have to prove the amount of the tax due, so long as there is proof of fraudulent evasion of some tax. Perhaps it might be reasonable to infer that even though the taxpayer incurred some unclaimed expenses in connection with the unreported receipts, these expenses would not be as great as the receipts· *i.e.*, that the additional unreported receipts produced *some* income, tax on which was evaded. In a civil fraud case, however, is there a greater burden on the government to establish the correct understatement of income, since the issue in a deficiency case, fraudulent or not, is the *amount* of unre-

ported income, whereas in a criminal case the issue is whether there was evasion of *some* tax?

3. It is sometimes said that the net worth-expenditure method of calculating income may be employed only if the taxpayer failed to keep books or if the books kept are shown to be inadequate or false. This view was based on § 41 of the 1939 Code [see §§ 446(a) and (b), 1954 Code], providing that

> net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of [the] taxpayer, but if no such method of accounting has been employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

But note this recent comment by the Tax Court

> The net worth method is not a system of accounting, it is not a substitute for either the cash or the accrual basis of accounting or any other recognized method of keeping books. When correctly applied to the facts of a particular situation, it is merely evidence of income And when the increase in net worth is greater than that reported on a taxpayer's returns or is inconsistent with such books or records as are maintained by him, the net worth method is cogent evidence that there is unreported income or that the books and records are inadequate, inaccurate, or false. It is not correct to say that the use of the net worth method is forbidden where the taxpayer presents books from which income can be computed, for the net worth method itself may provide strong evidence that the books are unreliable (*Lipsitz* v. *Commissioner*, 21 T.C. No. 107 (1954).)

Suppose the Commissioner, without pointing to any error in the taxpayer's regular books of account, asserts a deficiency based on a net worth computation. Can the government rest upon the usual presumption of correctness attaching to its assessments (assuming no fraud penalty is imposed or criminal prosecution undertaken), and wait for the taxpayer to prove that he had cash on hand at the beginning of the period or that he had recourse to nontaxable sources of income? Note that there is no statutory or administrative requirement that a taxpayer maintain books or records on a net worth basis, and that frequently taxpayers do not keep records of cash on hand at the beginning and end of the taxable year or of incidental non-taxable receipts.

4. For more on the subject of civil and criminal penalties for fraud, see *infra*, pp. 864-885.

CHAPTER 9

TAX PRACTICE AND PROCEDURE

Section A. Procedure in the Internal Revenue Service

1. *Deficiency Cases*

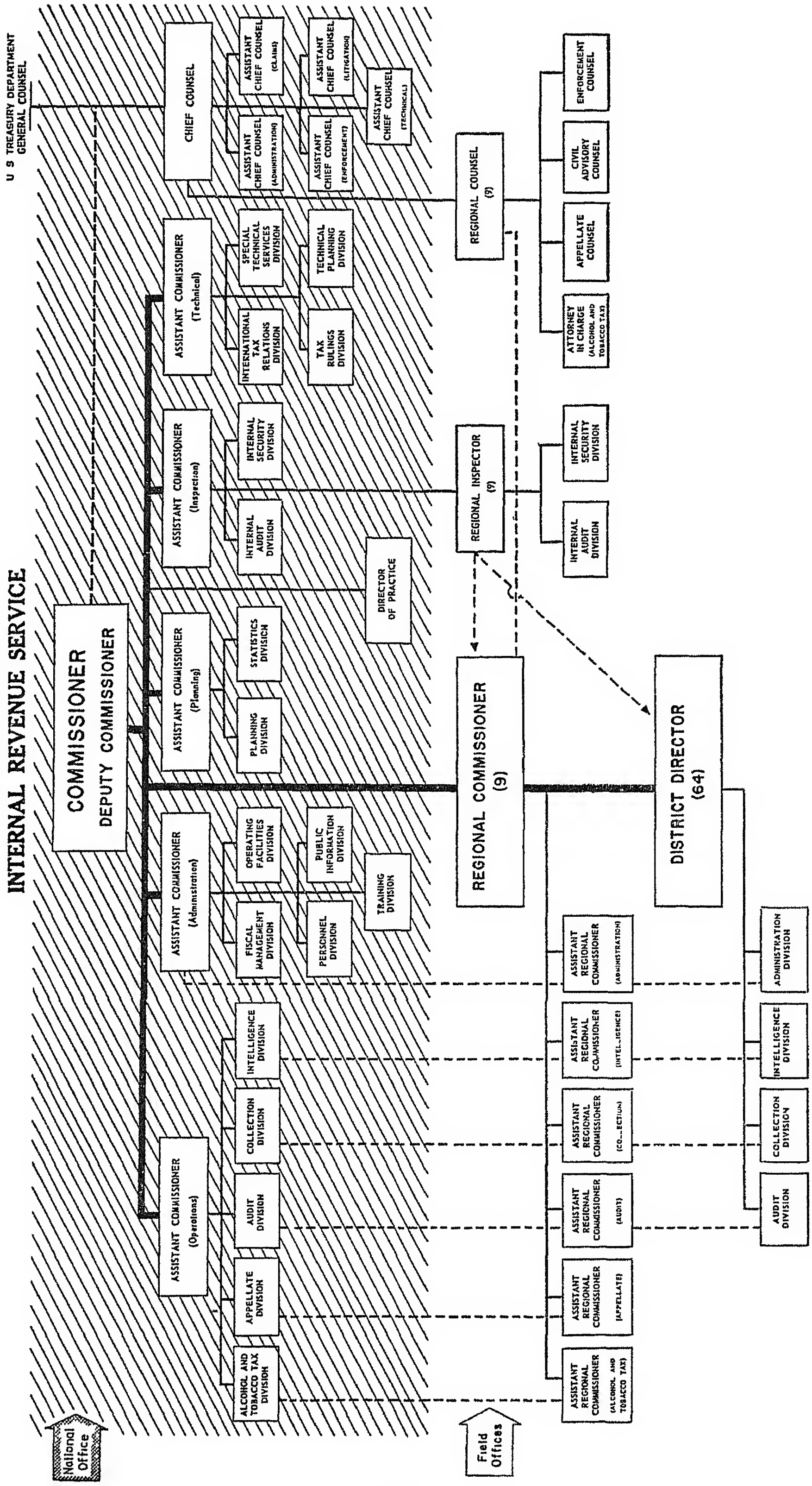
Although the federal income tax return is often referred to as a method of self-assessment, the term "assessment" is a technical one of great importance, referring to the action taken by the Commissioner of Internal Revenue under § 6201(a)(1) of the 1954 Code: "The Secretary or his delegate shall assess all taxes determined by the taxpayer. . . ." Pursuant to this and other authority, the Commissioner prepares an "assessment list," listing the names of taxpayers and the amounts of tax due. The assessment may be increased at a later date pursuant to § 6204 should an audit indicate that the tax due exceeds the amount reported on the return. The filing of a return by the taxpayer is thus the first step toward the assessment of tax.

After the assessment list has been prepared, it is transmitted to the proper District Director of Internal Revenue for collection of any amount not already paid. As will be seen hereafter, once a tax has been assessed, the District Director proceeds to collect it, either by suit or by distraint, and there is little that a taxpayer can then do to prevent collection, though he can still sue for a refund after collection. It becomes important, therefore, to see what steps are available to settle a dispute before an assessment is made.

The Internal Revenue Service, as the Bureau of Internal Revenue now calls itself,* has prescribed a rather elaborate process for settling disputes with taxpayers, and an assessment will not be made (except when collection of the tax is deemed in jeopardy) until these administrative steps have been taken. If they fail to produce an agreement, the Commissioner, under §§ 6212 and 6213, issues a so-called "90-day letter," notifying the taxpayer of the amount of the asserted deficiency and advising him that he has 90 days to file a petition with the Tax Court. If the taxpayer files such a petition, the assessment may not ordinarily be made until the decision of the Tax Court has become final; if no petition is filed, however, the assessment will be made when the 90 days elapse. The assessment will be followed by steps to collect the tax, though the taxpayer may still sue for a refund.

Only a fraction of all tax disputes culminate in a 90-day letter, and still fewer in litigation, so that the administrative procedure for adjusting disputes without the issuance of a 90-day letter is of great practical importance. This procedure was substantially revised when the Internal Revenue Service was reorganized in 1952.

* See chart, adjoining page.



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AUDIT DIVISION
COLLECTION DIVISION
INTELLIGENCE DIVISION
ASSISTANT COMMISSIONER (Administration)
FISCAL MANAGEMENT DIVISION
OPERATING FACILITIES DIVISION
PERSONNEL DIVISION
PUBLIC INFORMATION DIVISION
TRAINING DIVISION
ASSISTANT COMMISSIONER (Planning)
PLANNING DIVISION
STATISTICS DIVISION
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ASSISTANT CHIEF COUNSEL (ENFORCEMENT)
ASSISTANT CHIEF COUNSEL (LITIGATION)
ASSISTANT CHIEF COUNSEL (TECHNICAL)
National Office
Field Offices
REGIONAL COMMISSIONER (9)
REGIONAL INSPECTOR (9)
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ASSISTANT REGIONAL COMMISSIONER (COLLECTION)
ASSISTANT REGIONAL COMMISSIONER (INTELLIGENCE)
ASSISTANT REGIONAL COMMISSIONER (ADMINISTRATION)
DISTRICT DIRECTOR (64)
AUDIT DIVISION
COLLECTION DIVISION
INTELLIGENCE DIVISION
ADMINISTRATION DIVISION

The procedure we are interested in begins with an examination of the return by the Audit Division of the District Director's office. This Division receives the returns after they have been checked for mathematical errors by the Collection Division. The returns are then classified: some are accepted as filed; others are assigned to examiners for office audit, (where the taxpayer is asked to bring or mail pertinent records to the internal revenue office) or for field audit (where the examiner goes to the taxpayer's office or home for a more detailed examination of his books and records).

The Service, not surprisingly, does not announce publicly all the criteria determining whether returns will be subjected to audit or not. Returns reporting income above certain levels, altered from time to time in accordance with the agency's workload, are automatically assigned for audit. The returns of gamblers are apparently also "automatics," and it is said that the returns of physicians and of members of family partnerships have also been on the "automatic" list from time to time. Recently the Service has also used various sampling techniques to assign returns for automatic audit. In addition to the "automatics," returns are assigned for audit because of obvious errors on their face (such as the deduction of a loss on the sale of the taxpayer's residence) or because certain items seem to call for investigation (such as traveling and entertainment expenses out of proportion to gross or net income).

Experienced classifiers develop an uncanny ability to pick out returns that will be "productive of revenue" if audited. One author has said this about the selection of returns for examination:

> Those returns which are likely to be productive of revenue are set aside for examination. What causes those returns to be selected? The fact that they contain items involving:
>
> —reasonableness of compensation or depreciation;
> —bad debts in what are seemingly unreasonable amount;
> —various deductions not substantiated or sufficiently explained, such as casualty losses, medical expenses, legal expenses, deductions from salaries, traveling and entertainment expenses, and the like;
> —compensation reported under § 107 [§ 1301, 1954 Code];
> —losses from worthless stocks or bonds claimed as ordinary instead of capital losses,
> —sales of securities for nominal sums, indicating the possibility of worthlessness in prior years;
> —corporate returns which seem to indicate improper accumulation of surplus;
> —substantial items of cancellation of indebtedness;
> —substantial expense accruals shown in the closing balance sheet which might require the application of the two and a half months' rule.†
>
> Generally speaking, most of the items mentioned, will lead to examination only if the amounts involved are substantial. Whether they are substantial is a relative matter, and the amounts must be considered in relation to the other figures on the return.
>
> Aside from the list of items mentioned, which could be expanded indefinitely, there are a few other common matters which should be noted·
>
> —Deductions with three zeros, *i.e.*, in round figures, in cases where the figures would not ordinarily come out this way. Such figures indicate that they are estimates, rather than actual figures.
> —The lumping together of items of deduction may give rise to examination. For

† Section 267 (a) (2), *supra*, p. 667. [Ed.]

example, all taxes may be deducted in one sum without any breakdown. Not infrequently it has been found that federal income taxes are included in such a deduction.

—The omission of schedules or substantiation where called for by the return or instructions may give rise to examination.

(Arac, "How to Effect Settlements at Various Stages," *9th Annual N.Y.U. Institute on Fed. Taxation* (1951) 525, 526–7. (Reprinted by permission from the *Proceedings of the New York University Ninth Annual Institute on Federal Taxation*, published by Matthew Bender & Company, Albany 1, New York.))

The Service's audit program for the fiscal year 1954 was described in the following terms by Commissioner T. Coleman Andrews to a sub-committee of the House Committee on Appropriations:

A new "regular" audit program for 1954 has been developed to obtain the benefits of the integrated audit authority placed in the Directors' Audit Divisions under the reorganization of the Bureau. The core of this new program is the framework provided for selecting for examination each year the 2.5 million individual income tax returns (the estimated capacity to examine) most urgently in need of correction out of the 55 million returns which are filed annually.

To provide audit coverage for all tax returns at all levels of income, the new program requires (a) assignment to revenue agents for examination of about 125,000 form 1040 business returns with adjusted gross incomes of $30,000 and over and nonbusiness returns with incomes of $50,000 and over; (b) screening by experienced examining officers of about 1,500,000 form 1040 returns with adjusted gross income under the foregoing amounts but not less than $10,000; and (c) sorting, by low-cost clerical personnel, of the remaining 53,500,000 form 1040A and form 1040 returns with incomes under $10,000 between relatively "productive" and "unproductive" groups.

The productive groups obtained in (c) above number about 13,500,000 returns, which are then screened by experienced examining officers to select those most urgently in need of examination. Some of these productive returns with high refunds will be audited prior to the issuance of tax refunds in order to avoid erroneous refunding and resulting difficult collections problems. The relatively unproductive groups, about 40 million returns, are not screened. Selections, of a very limited number, for examination are made, however, by following "leads" from unmatched and mismatched tax-credit documents (forms W-2 and W-2a), income information documents (e.g. forms 1099), and examinations of related returns.

The program further provides screening methods for selecting other income-tax returns filed by corporations, partnerships, and fiduciaries. Also, it clearly enunciates the new Bureau policy of examining, wherever practicable, all federal tax returns filed by a business taxpayer at the same time that the income-tax examination is being made. To help implement this policy, provision is made to associate the related payroll and excise-tax returns with all automatic form 1040 business returns and automatic corporation income-tax returns.

In appraising the new audit program, a number of items should be noted. (1) It more specifically directs the screening efforts of examining agents to the 15 million more productive individual returns, (2) it gives the examining agents more time for actual examination work because of the elimination of the need to screen 40 million individual returns which formerly was required; and (3) it encourages a full-coverage examination at the same time of all classes of Federal taxes to which a taxpayer is subject.

It is within this general category of regular audit work that we can expand or contract our efforts depending entirely upon the manpower available to us. The number of returns in this group is 15 million and present indications are that we will audit some 2,500,000 of them. The size and nature of these returns are such that we could audit with profit at least another 5 million if we had the manpower. On the other hand, the number we estimate that we can audit with the funds requested will have to be reduced if the additional force requested for back tax collections work is not provided, or it will have to be reduced if added manpower becomes necessary in some

other more pressing area. In other words, this is the only area in which major adjustments in our forces can be made as a result of substantial budget changes or as a result of large unforeseen contingencies. (Hearings, Treasury-Post Office Department Appropriations for 1954, House Committee on Appropriations, 83d Cong., 1st sess., 608–9.)

About $138 million of the Bureau's $272 million budget was requested for investigation and audit of tax returns. In requesting this amount, the Commissioner indicated that it was less than the Service thought desirable:

We would like to be examining, as I say, about 2½ times as many individual returns as we are, because we think it would pay off in greatly increased revenues; from $10 to $15 additional revenue for every dollar we spend. (*Id.*, 626)

The selection of returns for audit is obviously a critical point in the revenue process, for while a return that is accepted as filed is not immune from reexamination until the period of limitations has run, it will almost certainly not be pulled out of its resting place unless the examination of a subsequent return or some other such development so dictates.

In an effort to test the effectiveness of the audit process and to ascertain how many returns might be "productive of revenue" if audited, the Service recently conducted an "Audit Control Program." The results of part of this Program, an intensive examination of a sample of individual returns for 1948, were illuminating. The study indicated that one-quarter of all individual returns for 1948 contained errors of $2 of tax or more, 90 per cent of which were in favor of the taxpayer. The percentage of erroneous returns, not surprisingly, steadily increased with income, with 72 per cent of returns reporting $100,000 of income or more containing errors. The average error on returns reporting $100,000 of income or more was over $2,500. In the aggregate, individual tax liability was understated by about $1.4 billion, almost 10 per cent of the total liability actually reported on these individual returns. A substantial part of this liability, which if detected would be increased by interest and penalties, escaped discovery because of lack of manpower. See Farioletti, "Some Results from the First Year's Audit Control Program of the Bureau of Internal Revenue," 5 *Nat'l. Tax J.* 65 (1952); Bureau of Internal Revenue, *The Audit Control Program: A Summary of Preliminary Results.*

The Audit Control Program also demonstrated that the expense of auditing tax returns is far below its yield: an examination of Forms 1040A (adjusted income less than $5,000, not more than $100 of which is from wages not subject to withholding and from dividends and interest) would produce $9,400 per year per examiner; and the potential yield rises steadily with the size of the returns being examined, with an examination of returns reporting $100,000 of income or more producing $197,000 of revenue per examiner per year. The Audit Control Program has also increased the Service's knowledge of the type of errors made by various classes of taxpayers. The principal error on small returns, for example, is the claiming of unwarranted personal exemptions; this error is rarely found on large returns. Moreover, a taxpayer will rarely incorrectly claim or invent a wife or child, but erroneous deductions for parents and other relatives are common. Thus, out of 43 million small returns listing no dependent relatives (*i.e.*, persons other than a spouse and children), only one out of 53 contained an exemption error; out of 6 million such returns listing dependent relatives, one out of five was

erroneous. Another common error on small returns is the omission of dividend ‡ and interest income, errors which are ordinarily small and costly to find by audit. Errors on small returns would undoubtedly be far more numerous were it not for the optional standard deduction. Only one return out of 250 contained an error in using the standard deduction (presumably such errors as the taking of personal deductions in addition to the standard deduction or errors in computing the standard deduction itself), but out of 9 million returns itemizing personal deductions (taxes, medical expenses, charitable contributions, and interest), 3 million were erroneous.

Obviously, intensive examination of returns is not the only remedy—or indeed the best—for many types of errors. In recognition of the frequency of error in dependency claims for dependent relatives, the returns for 1951 and later years have required the taxpayer claiming such exemptions to answer specific questions as to the amount of support contributed by him and by others and the gross income of the dependent. This step should bring home to the taxpayer the requirements for claiming a dependency exemption more effectively than the older return, which only required the relative's name, relationship, and address. Form 1040 has also been revised to require an itemization of interest and dividend income, whereas previously a simple total was sufficient. Section 6042 grants to the Commissioner authority to require corporations to report dividend payments to shareholders; and the minimum payment which must be reported has been reduced by him from $500 to $100 and then to $10. Similarly, interest payments were formerly reportable by the debtor only when in excess of $600; Section 6041(c) was amended in 1951 to permit the Treasury to require full reporting of interest payments, but it has not exercised its full authority as yet. The service has recommended the more thoroughgoing step of withholding tax on dividends and interest (to be credited, like withheld wages, on the recipient's tax liability). This proposal, as to dividends alone, passed the House in 1950, but was eliminated by the Senate. See 50-2 C.B. 406-08, 521.

For taxpayers as a whole, information returns, withholding of tax, intelligible forms, and dispersion of instructions for completing the return are basic steps in enforcement. Improvement in such techniques for preventing or easily detecting simple errors would leave the Service's examiners with more time for auditing the complex returns, while scientific studies like the Audit Control Program can sharpen the methods of identifying those returns in need of audit.

No matter how the service may improve its criteria for selecting returns that will be "productive of income," however, there will remain knotty questions of policy in the assigning of a limited number of man-hours. If the large returns will produce the largest additional revenue per hour of examination, should agents be assigned exclusively to this work, at least until further studies show that neglect of the small returns has increased the errors in them? If physicians characteristically receive and omit larger amounts of cash fees than lawyers, should the former group be subjected to automatic audit? If tracking down the errors of gamblers and bookmakers is more expensive per dollar of revenue produced than examining the returns of business men, how many of a limited group of agents should be assigned to "racketeer" duty? Would

‡ Now that the first $50 of dividends may be excluded, *supra*, p. 456, there will of course be fewer "errors" in the reporting of small amounts of dividend income.

a wholly random selection of returns for audit produce a psychological effect upon taxpayers compensating in the long run for initially unrewarding results? In the same vein, would it be desirable that every taxpayer be subjected to at least one examination periodically? How does the audit of one taxpayer, or a group of taxpayers, affect others who hear of the audit? The findings of the Audit Control Program that are summarized above were based on the assumption that the representative sample disclosed the percentage of error across the board. This may be true for any one year's returns, but what will be the effect on the returns for next year, if, before they are filed, extensive audits have been conducted on last year's returns? Is a door-to-door canvass a desirable technique for detecting persons who fail to file or for frightening them into coming forward? Will such methods stimulate resentment towards the Service among law-abiding citizens? Are they incompatible with democratic government?

To return now to the process of auditing a return, as the taxpayer sees it:

Those returns that are selected for audit are referred either to the Office Audit Branch (of the Audit Division, District Director's office) or to the Field Audit Branch, depending upon whether the examination is to be conducted by correspondence or by an appearance of the taxpayer at the revenue office, on the one hand, or by a field examination of the taxpayer's books and records at his home or place of business. In the former category fall small returns and those on which only a single item is questionable; larger returns and those presenting more complex issues are assigned for field examination.

In making its examination, the Service is armed with the power to take the testimony of the taxpayer and others having knowledge of the matters to be investigated and to require the production of books and records of the taxpayers and others. §§ 7601-07, 7210. This investigative power is, of course, limited by the Fifth Amendment, but an important area of current uncertainty is whether the taxpayer may refuse to produce the books and records which he keeps pursuant to § 6001. *Supra*, p. 102. See generally Mickey, "The Investigative Powers of the Bureau of Internal Revenue," *10th Annual N.Y.U. Institute on Fed. Taxation* (1952) 685. In the overwhelming majority of audits, the taxpayer is entirely cooperative in making his records available. Except in fraud cases, and not always even then, there is seldom any advantage in seeking to withhold them.

If the examiner is satisfied that the return reports the proper amount of tax due, he will recommend that the return be accepted as filed and, after his report has been approved by a reviewer, the taxpayer will be so notified. If, on the other hand, the examiner believes that an adjustment in favor of either the government or the taxpayer is required, he will inform the taxpayer of his findings and offer him an opportunity to execute an agreement form, ordinarily Form 870. (There are special forms for partners, fiduciaries, and corporations filing consolidated returns.) This form, entitled "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment," is reprinted on p. 817.

The effect of Form 870, which will be considered further, *infra*, p. 807, is often misunderstood. By signing it, the taxpayer consents to the immediate assessment of the tax agreed upon, without the issuance of a 90-day letter. Since the 90-day letter is the indispensable foundation for a petition to the Tax Court, a taxpayer waives his right to go to that court by executing Form 870. He does not, however,

waive his right to sue for a refund after paying the agreed deficiency. The Commissioner, for his part, waives the right to collect interest on the deficiency for the period commencing 30 days after Form 870 is executed and ending with the assessment itself. Since it may take some time to make the assessment, Form 870 protects the taxpayer against the running of interest during this period though he need not pay the tax until it is assessed. It should be noted that the Commissioner does not waive his right to increase the deficiency should he later so determine, although if he does so the taxpayer's right to a 90-day letter and thus to file a petition with the Tax Court is reinstated. If an overassessment, rather than a deficiency, is found by the examiner, Form 870 authorizes the service to proceed to make a refund without discussing the amount further with the taxpayer.

If the taxpayer signs Form 870, the examiner prepares a report, which is subject to review by the Audit Division and by a post-audit review group in Washington. Rarely will an agreement be upset in Washington. The service's announced policy is that

> no case closed by an agreement will be returned for reconsideration by the Director unless the post review discloses a clearly defined misapplication of law, misrepresentation of material facts, or an important mistake in mathematical calculation resulting in substantial change in tax liability.

This instruction (54–3 P-H Fed. Tax Serv. ¶ 21,006) contemplates that most errors will go uncorrected, though the field will be notified of the error for guidance in handling other cases.

When the examiner explains his findings to the taxpayer, he may not wish to sign Form 870. In that event, the examiner will furnish the taxpayer with a brief written statement of the proposed adjustments and will advise him that he may have an "informal conference" to discuss the proposed adjustments with the examiner's group chief or with some other employee designated by him. In keeping with the purpose of the "informal conference," the examiner does not prepare a formal report nor is the taxpayer required to file a protest, brief, or other statement, lest positions become crystallized before the dispute has been fully discussed.

If after this informal conference the taxpayer accepts the examiner's conclusions (which may be modified as a result of the conference), he will have another opportunity to sign Form 870, and the examiner's report will be processed as previously described. If the taxpayer does not agree, the examiner prepares a report which (after review) is transmitted to the taxpayer with a so-called 30-day letter. Such a report and 30-day letter will also be sent to the taxpayer if he chose in the first instance to forego an informal conference.

The 30-day letter sets in motion a somewhat more formal set of administrative maneuvers. Once more, the taxpayer is offered an opportunity to execute Form 870 or to pay the tax without waiting for an assessment. Alternatively, he may ignore the letter altogether; if he does so, when the 30 days elapse, he will receive a 90-day letter, which gives him for the first time an opportunity to file a petition with the Tax Court. In most cases, however, the taxpayer avails himself of the opportunity offered in the 30-day letter for filing a protest and participating in a conference.

The protest is a more or less elaborate statement of the taxpayer's objections to the proposed adjustments, together with a claim for any adjustments favorable

to himself that were either not previously discussed or were discussed and rejected. The conference, if requested, will be held with the Appellate Division (formerly the "Appellate Staff" and, earlier, the "Technical Staff") of the Regional Commissioner's office, *i.e.*, with a staff independent of the examiner previously dealt with. The head of the Appellate Division is the Assistant Regional Commissioner, Appellate, who has the power to settle all income tax cases, with only five qualifications: (1) Appellate Counsel (responsible to the Chief Counsel of the Bureau) must concur in the settlement of any case docketed in the Tax Court; (2) Appellate Counsel must concur if any fraud or negligence penalty is to be eliminated; (3) no case in which criminal prosecution has been recommended can be settled until final disposition has been made of the criminal aspects of the case; (4) his decisions in cases involving overassessments or overpayments in excess of $100,000 (formerly the amount was $200,000) are subject to review by the Chief Counsel and by the Congressional Joint Committee on Internal Revenue Taxation.§ The Assistant Regional Commissioner, Appellate, may in turn delegate his settlement authority, within certain limits, to his subordinates.

Procedure in the Appellate Division is described in the following article by the national head of that division.

STOWE

AUDIT, INFORMAL CONFERENCE, AND APPELLATE PROCEDURES IN THE REORGANIZED BUREAU

94 J. Acc'y 298, 300–1 (1952)
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Nondocketed Cases. The procedure in the Appellate Division in a case which is not docketed in the Tax Court begins with the receipt of the administrative file from the office of the [District] Director of Internal Revenue. The case is then assigned to a conferee who, after studying the examining officer's report, and taxpayer's protest, any informal conference report, and the other documents in the file, communicates with the taxpayer or his representative and arranges for a conference. If the case involves an important and novel question of law, the conferee may request legal advice from Appellate Counsel in connection with his

The procedure at the conference is informal. No stenographic record is made. Here also, the taxpayer may appear with or without representation, depending upon his own desires, and he may bring such witnesses as he considers advisable, for the purpose of assisting in establishing the facts. However, if additional statements of fact are to be added to the record, the taxpayer is required to have them reduced to writing and submitted in the form of affidavits. If important evidence bearing upon a basic issue in the case is presented for the first time after the case is in the Appellate Division, the data will be returned to the Director so that they can be verified. The Appellate Division does not have any investigative staff of its own and the taxpayer may not withhold evidence from the Director and present it for the first time on appeal.

Taxpayer May Propose Disposition of Case. The case is fully discussed at the preparation of the case.

§ On the role in this area of the Joint Committee, see Reiling, "Tax Refunds Over $200,000 Require Special Handling; Bureau Office Explains Procedure," 95 *J. Acc'y* 567 (1953).

conference and an opportunity is provided for the taxpayer or his representative to submit a proposal for disposition of the case. Such a proposal is carefully considered by the conferee, and the taxpayer or his representative is advised, at the conference or after further study, as to whether the conferee will recommend acceptance of the proposal for settlement. If the conferee is willing to recommend acceptance, he secures an agreement form which, when accepted on behalf of the Commissioner by the authorized officer of the Appellate Division, will be treated by the bureau as a final disposition of the case.

The conferee then prepares his report in the form of an action memorandum and supporting statement which is submitted to his immediate superior for review. In the New York City District this superior will be a Special Assistant to the Head of the Appellate Division, who is somewhat of a combination conferee-reviewer and group chief and who supervises a number of conferees.

If the Special Assistant approves the proposed settlement, he will accept the agreement on behalf of the Commissioner if the case is within his delegated authority and the case is ready for closing. If the case is not within his delegated authority, he will transmit it to the Assistant Head of the Appellate Division for review and acceptance.

Should the Special Assistant decide that he cannot approve the proposed settlement, he will discuss the case with the conferee and point out the reasons for his decision. If, after this discussion, the Special Assistant still is unwilling to approve the proposed settlement, the taxpayer will be notified of that fact and may ask for a hearing before the Special Assistant.

If the taxpayer does not agree with the conferee's decision, the action memorandum and supporting statement, together with the draft of the proposed statutory notice, will be reviewed by the Special Assistant. If he approves, the case will go to the Assistant District [now Regional] Commissioner, Appellate, who—after his review and after consideration of the statutory notice by Appellate Counsel—will issue the statutory notice to the taxpayer or direct its issuance by an authorized officer of the Appellate Division, and route the case to the Appellate Division's ninety-day file.

Appellate Division procedure in cases that are docketed in the Tax Court provides further settlement opportunities. As previously explained, docketed cases may result from petitions filed in respect to statutory notices issued by the Director in cases which were not before the Appellate Division in nondocketed status, or from petitions filed in response to statutory notices issued by the Appellate Division after it has considered the cases in nondocketed status. In the cases not previously considered in nondocketed status, the petitioner is offered a conference similar to that employed in nondocketed cases. If the case is one which the Appellate Division considered, but was unable to arrive at a settlement, in nondocketed status, the initiation of settlement negotiations is ordinarily left to the petitioner or occurs when the attorneys meet for the purpose of stipulating facts for trial purposes.

In either event, if a satisfactory settlement is arrived at, the conferee will prepare an action memorandum and supporting statement for review and approval by his superior and for concurrence of appellate counsel. If accepted, the settlement will be stipulated before the Tax Court and the case closed in that manner. If rejected, settlement negotiations may be reopened or the case will be tried.

ARAC

HOW TO EFFECT SETTLEMENTS AT VARIOUS STAGES*

9th Annual Inst. on Fed. Taxation 525, 533, 537–9, 542–4, 547, 549–50 (1951)
(Reprinted by Permission)

What is the agent's primary function in making his examination of any one of the items which we have mentioned? His function is to raise issues and develop facts. If he raises the issue of correctness of travelling expenses, he will require the taxpayer to furnish proof as to actual travel, and the amount spent. In doing this, the agent is attempting to determine the true tax liability on the basis of the facts in the case. To describe his function differently, he has to determine whether all items of income have been properly reported, and whether all the deductions claimed are allowable. He is the finder of the facts, and on those facts will depend the determination of true tax liability. It is for this reason that the practitioner should devote a great deal of attention to presenting the case to the agent. In a practical sense, the agent has more power than anyone else to accept a return by his findings of fact. He has the power to do this without examination of taxpayer's records, if his study of the return indicates that an examination would produce no material change in the tax liability. And, if he examines the taxpayer's return and determines the facts in the taxpayer's favor, that determination will generally stand. It is far easier for a conferee to accept an agent's recommendation or statement than to reverse it. . . .

How far can the agent go in the disposition of cases? His duty is to raise issues and develop facts. He does not have authority to settle cases in the way that a conferee may. He does not have the right to concede one issue in an attempt to reach an agreement on other issues. Nevertheless, that is exactly what agents are doing every day. If they did not, conference would be flooded with cases. As previously noted, the agent probably exercises more power in a case than anyone else. If he raises an issue, it is in the case. If he does not, the chances are that the issue may never be raised.

As a practical matter, if an agent feels that he is protecting the revenue by making a reasonable settlement on the government's behalf, he will make the settlement. But a compromise of amount seems possible only where the full and correct facts are not readily available. Many agents will refuse to settle an issue where the law is doubtful. They prefer to throw the case into conference.

Negotiating The Settlement

The practitioner should try to decide in advance the best position to take on the matters in dispute, by considering his chances of success or failure on each issue. He should also try to compute the tax liability which will result from winning or losing each issue. This computation will give him a practical view of the relative importance of each issue from a dollars and cents point of view, and will guide him in determining what concessions he can afford to make. He

* This discussion of strategy in dealing with the Service, though written prior to the 1952 reorganization and consequently somewhat outmoded so far as certain procedural steps are concerned, is still of interest. [Ed.]

should also consider the effect, if any, which adjustments in the taxable year involved will have on subsequent years, in weighing the advantages and disadvantages of possible settlement.

After these preliminaries, the practitioner is in a position to discuss with the agent his proposed findings. He may conclude, as to some of these findings that the agent is wholly wrong, and that these will be reversed in conference. In that event, there is nothing to be gained in disturbing the incorrect findings when it is obvious that the case must go to conference. If the agent advances the same contentions in his report, his report will be weakened because the conferee will feel that he was unreasonable. This reaction may contribute to a better settlement on behalf of the taxpayer.

In the discussion with the agent it is advisable to concentrate on those of his findings which have merit, and to argue those fully. When it is found that further argument is useless, and the time arrives for a possible settlement, should the practitioner make the first offer? Obviously, it is advantageous to get the agent to make it, since it may give some indication as to what he thinks of his own case. In this connection, if any possible offsets have been found, it is helpful to bring them out at this point.

Evaluate the Man

The practitioner should not only evaluate his case, but he must also evaluate his man. He must never lose sight of the fact that although he is dealing with facts, law, regulations, *etc.*, throughout the process of settlement, he is dealing with an individual. Some agents are tough, and some less so, some are tenacious in holding to their views, and others are more easily swayed, some have a splendid grasp of the law, and others are less well informed. He will be able to size up his man after he has spent some time with him. His conclusion in this regard will influence his course of action.

Some agents will give up on nothing unless the taxpayer is 100% right. If that is the case, it is useless to prolong the negotiations. Some agents will settle a case if they think the taxpayer has an even chance of reversing them in conference. In the same situation, other agents will take the position that conference should settle the case. Some agents are good traders, and will try to drive the best bargain in order to protect the government's interest. Others are not good traders, and can be argued into a favorable settlement from the taxpayer's standpoint. . . .

Conference

Assuming that a thirty day letter has been issued, the practitioner is confronted with the problem whether he should protest the proposed deficiency and go to conference.

Dangers Inherent in Going to Conference

The answer in the first instance depends upon whether he feels that he can convince the conferee that the agent was wrong. But even if he is confident that he can do so, he will bear in mind that there is a definite risk in going to conference. This risk arises from the very nature of an income tax case. Even though one item may be in dispute, every transaction occurring during the taxable year may be put in issue. Before deciding to go to conference, he should make a

thorough review of the transactions of the taxable year involved. He may come up with an offset. On the other hand, he may find hidden dangers lurking in the case, and he may decide to let sleeping dogs lie, and agree to the deficiency. A striking instance of this sort of hidden danger is found in the *Raskob* case.[1] There the taxpayer appealed from a $15,000 deficiency. Before he was through, the Tax Court found a deficiency of over $1,000,000.

Informal Conference with Agent

If he has come into the case after the issuance of the thirty-day letter, it may be wise to seek an informal conference with the agent before deciding to go to conference. The discussion might reveal facts and matters that do not appear in the thirty-day letter; or facts that his client failed to tell him about. He might get a hint that the agent's conclusions are based on an unpublished ruling. The more he knows about the case, the more effective he can be.

The Protest

Assuming that it has been decided to go to conference, and the protest has to be prepared,[2] how complete shall it be? There are two schools of thought as to the statement of grounds on which the taxpayer relies. One school prefers to make a complete presentation of the case, setting forth in considerable detail each and every argument in support of each and every ground. The other school of thought prefers to state conclusions, in order to leave the greatest latitude in dealing with the conferee. The theory is that the function of the protest is simply to get the case before the conferee, and since it is not the final document if a hearing is requested, it is wise not to fire all the ammunition before going to the hearing. This is a highly controversial point, and personal preferences will be the deciding factor. A complete statement makes a better impression on the conferee, and avoids loss of time. It may even result in the disposition of the case without the necessity of a formal conference. In any event, if the protest is not complete in every respect, the practitioner should be fully prepared both on the law and facts, and should have all necessary evidence with him when he comes to conference.

Sometimes practitioners include in their protest issues on which they themselves know they have no chance. Their idea seems to be that they can trade these off. But the practice seems unwise because it creates a poor impression on the conferee.

In preparing the protest, it is a good idea not to anticipate issues which it is believed may be raised, but which the examining agent has not raised. To do so may cause a good deal of unnecessary trouble.

What Can One Get From Conference?

Is there a greater chance of settling a case with the conferee than with the agent? Generally speaking, there is. The conference procedure was set up by the Bureau for the purpose of settling cases without litigation. It is the conferee's job to settle cases, and he has authority to make concessions—something which the

[1] 37 B.T.A. 1283, aff'd. 118 F.2d 544 (3d Cir. 1941).

[2] For a discussion of the problems involved in the preparation of a protest, see Rabkin, "The Preparation of Protests and Briefs," *6th Annual N.Y.U. Institute on Fed. Taxation*, 231 (1948).

agent has no authority to do. The agent is concerned with making an examination and developing the facts. He has to think about "production." The conferee spends his time weighing and evaluating the facts of a case which has already been worked up. He can concentrate on the job of settlement. This difference in point of view can and does result in more settlements with the conferee. In addition, the conferee has broader knowledge and experience. In contrast with the examining agent, he has an overall view of various types of cases. An agent may deal with a particular issue occasionally. A conferee may meet the same issue time and time again....

Technical Staff

Supposing that no agreement with the conferee has been reached? Should the case be taken to Technical Staff? †

The same factors which were considered in deciding to go to conference should be reviewed. Every time there is a conference with Bureau officials without reaching an agreement the taxpayer has lost ground. His case has been more thoroughly considered by more experienced officials, every unfavorable admission which may have been made is noted, and the chances of additional deficiency have been increased. If the dispute eventually goes to court, the entire case will be known to the government representatives. The reverse side of the picture, however, is that the staff settles about two-thirds of all the cases which are submitted to it. There also seems to be a greater tendency on the part of the Staff to settle larger cases than is shown by agents or conferees....

Staff "Entertains" Settlements

The Staff takes the position that it does not propose settlements, it entertains them. Where substantial uncertainty exists either in law or fact, or both, as to the correct application of the law to the particular case, the Staff will seriously consider an offer of settlement on a basis which fairly reflects the litigating possibilities of a case, *i.e.*, the strength or weakness of the opposing views. Since the main consideration influencing the Staff is the taxpayer's chance to win in the Tax Court, the practitioner should demonstrate that he understands the strength of his case, and that he is not afraid to go on trial. It is not advisable, however, in the course of the conference, to discuss the proof in detail, to exhibit the documentary evidence, or to disclose the identity of the witnesses.

In a case involving several issues, the Staff may trade issues in order to effect a settlement, even though no concessions would be made on each issue standing alone. But this will be done only if a binding precedent is not set. Sometimes, the Staff will split an issue, where there is a single issue in the case, in order to effect a settlement. This is done as a matter of expediency, in view of the large volume of litigation, but only in cases in which the Staff believes that the issue will not recur in later years.

Note

1. See also Spencer, "Income Tax Controversies with the Internal Revenue Agent in Charge," 64 *Harv. L. Rev.* 547 (1951) (based on pre-1952 procedures, but still valid in

† Now the Appellate Division, Regional Commissioner's office. [Ed.]

large part); Casey, "Settling a Case with the Chief Counsel's Office," *7th Annual N.Y.U. Institute on Fed. Taxation* (1949) 213; Bickford, *Successful Tax Practice* (2d ed., 1952, Chapters 13–15).

2. From time to time suggestions have been made that the task of administering the tax laws be placed in an agency independent of the Treasury Department, partly to immunize administration from the Treasury's views of proper fiscal policy. See Surrey, "A Comment on the Proposal to Separate the Bureau of Internal Revenue from the Treasury Department," 8 *Tax L. Rev.* 155 (1953). As the *Dobson* case, *supra*, p. 749, points out, the Tax Court is the descendant of an office in the Bureau of Internal Revenue

2. *Refund Cases*

Turning from deficiencies in tax to overpayments, we find that the largest group of overpayments by taxpayers result from an excess prepayment (by withholding or payments on account of estimates) of tax. During the period January 1 – June 20, 1952, for example, the service received about 29 million individual income tax returns reflecting prepayment of 1951 tax in excess of reported liability. In the interest of taxpayer good will, the Service endeavors to make the adjustment (usually a refund; sometimes a credit against unpaid taxes for other years) as rapidly as possible. By July 31, 1952, all but 200,000 of these returns had been processed, resulting in refunds totalling $1.9 billion and credits totalling $180 million. These refunds and credits are made more or less automatically, and some of the returns involved will upon audit require readjustments in the government's favor. This may sometimes mean a revenue loss, if the taxpayer in question is insolvent or cannot be found, and in any event it is expensive to pursue the taxpayer for a refund of the refund.

Another time when an overpayment of tax may come to the attention of the service is upon audit of the return. It has already been seen that the examiner may propose an overassessment instead of a deficiency. Or, when he disputes the year in which a particular item is deducted, he may propose a deficiency for one year and an overassessment for another. Likewise, in family partnership or *Clifford* trust cases, a proposed deficiency for one taxpayer may be accompanied by a proposed overassessment for a related taxpayer. The taxpayer may "accept" the proposed overassessment by signing Form 870, and the Service, if the examiner's report is approved after the usual review already described, will proceed to make an appropriate refund or credit. If the taxpayer does not wish to sign Form 870 (either because he believes the proposed overasessment is too small or because it is linked to a deficiency to which he does not wish to agree), he may obtain the customary "informal conference." If no agreement results from the conference, the taxpayer will receive a 30-day letter. If he signs the Form 870 that accompanies the letter, or fails to protest, the proposed overassessment will be processed. If there is no agreement, however, the proposed overassessment (which, of course, may have been either reduced or increased from the examiner's original recommendation) will be processed and if the taxpayer is dissatisfied, he may file a refund claim.

It is very important to note that there will be no 90-day letter, or opportunity to go to the Tax Court, on an overassessment. That Court has jurisdiction only when a deficiency is asserted. To be sure, when a deficiency has been asserted, the Tax Court may redetermine the entire tax liability for that year and thus find that

the taxpayer has overpaid. It cannot, however, take jurisdiction of a year for which no deficiency has been asserted. Thus, whenever the taxpayer feels that he has overpaid by more than the overassessment proposed by the Service, his only recourse is a claim for refund and, if it is rejected or not acted upon, a suit in a United States District Court or in the Court of Claims. Moreover, just as the taxpayer may "agree" to a deficiency by signing Form 870, pay the resulting assessment, and then sue for a refund, so he may "accept" an overassessment on Form 870, receive the refund or credit so calculated, and then sue for any additional refund to which he may be entitled.

A tax refund claim may also arise because the taxpayer, after filing his return and paying the tax reported, finds on his own initiative that he miscalculated his liability, or that a change in the law has converted a proper payment into an overpayment. It will be necessary for him to file a claim for refund, since until such a claim has been rejected by the Service or has been before the Service for a period of time without action, he may not sue in the District Court or in the Court of Claims. Since the Tax Court, as already explained, has jurisdiction only when the Service asserts a deficiency, the taxpayer in the situation just described cannot go to the Tax Court in any event.

Thus, whether the taxpayer is acting on his own initiative or is objecting to an overassessment as to niggardly, he must file a refund claim with the Service. Such a claim has a double aspect: It sets in motion administrative procedure (substantially the same as is employed in deficiency cases) to consider the merits of the taxpayer's position; and it is the indispensible first step toward litigation.* The taxpayer with a possible refund claim must think carefully before he sets the Service in motion, since the return itself and possibly returns for other years as well, not just the refund claim, will come under scrutiny. It may be better to let sleeping dogs lie.

If a refund claim is to be filed, it must be drafted with a realization that it is a kind of pleading for any subsequent litigation and will, therefore, restrict the taxpayer in the issues that may be raised later. See § 7422(a). In this respect, refund procedure is quite different from deficiency procedure. The taxpayer may resist a deficiency in the Tax Court on any ground he wishes, whether it has been argued in the Service or not. Indeed, when an examiner first proposes a deficiency, the taxpayer may request that the 90-day letter be issued without further ado and then file his petition in the Tax Court without having previously informed the Service why he thinks the deficiency is improper. In suing for a refund, however, he is confined within the limits he himself set out in the claim filed with the Service.

BRODSKY
SUITS FOR REFUND: THE NATURE OF THE SUIT AND THE PROCEDURE TO BE FOLLOWED

11th Annual Inst. on Fed. Taxation 749, 756–759 (1953)
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The limitation period on the filing of claims for refund of income taxes is three

* On rare occasions, however, the taxpayer may be able to sue in the Court of Claims on an account stated without filing a claim for refund. See Note, 56 *Harv. L. Rev.* 115 (1942).

years from the date the return was filed,* or two years from the date the tax was paid † . . . Different periods for filing claims are provided for in the special cases of refunds of income taxes claimed on account of bad debt deductions, losses from worthless securities, and net operating loss carry-backs.‡ An exception is also made in the case of waivers of the Commissioner's time within which to make assessments (Form 872). In such cases, the taxpayer has until the expiration of the waiver period plus six months within which to file the claim for refund.‖ An amendment made in 1950 provides that in no case shall the time to file a claim for refund expire prior to two years after the tax was paid.

The content of claims for refund must follow provisions contained in the regulations. For income taxes, the regulations provide that "the claim must set forth in detail each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof." . . .

Grounds Stated in Claims

The grounds mentioned in the claim for refund are extremely important. They limit the issues upon which the taxpayer can rely in his suit for refund. If a ground is not mentioned in the claim for refund, it cannot be relied upon in the suit. The courts have been quite strict in limiting the taxpayer to the exact grounds named in the claim for refund. This strictness is illustrated in *Young* v. *United States*, 103 F. Supp. 12 (W.D. Ark. 1952). The taxpayer there had filed returns for 1944 and 1945 and then for two short periods, January 1 to September 30, 1946 and October 1 to December 31, 1946. In the last period there was a net operating loss. The taxpayer filed a claim for refund seeking a net operating loss carry-back for 1944. The Court held against the taxpayer, pointing out that 1944 was the third preceding taxable year, and not the second preceding taxable year as required by the statute. The reason for this was that the short taxable period January 1 to September 30, 1946 was the first preceding taxable year and 1945 was the second preceding year. The Court said that while the taxpayer was mistaken in naming 1944, the selection of the year was intentional. The carry-back could have been claimed for 1945, but the Court held it was helpless to grant relief, since the year named in the claim for refund was not the year upon which the suit was based.

In another recent case, *Nemours Corp.* v. *United States*, 188 F. 2d 745 (3d Cir., 1951), cert. den. 342 U.S. 834, the taxpayer's claim for refund relied upon one relief section of the code. In the suit for refund the taxpayer placed reliance upon a different but related relief section of the code. The Court held that the taxpayer was precluded from reliance upon the section not named in the claim for refund. It was considered that that was a different ground from the section named in the claim. The technical nature of the holding is emphasized by the circumstance that all of the facts necessary for a recovery were included in the claim for refund. The mere failure to cite another section of the code as a ground for refund doomed the taxpayer's case.

Amendment of Claims

When a taxpayer discovers that he has failed to state an important ground in a

* Section 6511(a); under the 1954 Code the time runs from the time the return was *due*. [Ed.]
† Section 6511(a). [Ed.]
‡ Section 6511(d). [Ed.]
‖ Section 6511(c). [Ed.]

claim for refund, he may seek to amend the claim. Amendments are subject to a number of rules which the Courts have developed. Before the expiration of the period of limitations on filing claims and before the Commissioner has rejected the claim, any amendment is permitted. But if the Commissioner has rejected (or allowed) the claim and thus taken final action upon it, no amendments may be made.

The only situation of any complexity arises for amendments after the expiration of the period of limitations but before the Commissioner has completed action on the claim. In this category, amendments are permitted which state in greater detail the grounds named in the original claim, or state additional facts in support thereof. But new or different grounds from those named in the original claim cannot be added by amendment. There is one exception which was established by the Second Circuit Court of Appeals in *Pink* v. *United States,* 105 F.2d 183 (2d Cir., 1939). An additional ground may be named in an amendment if it is closely related to the grounds in the original claim. The test for determining such relationship is whether the facts upon which the amendment is based would have been ascertained by the Commissioner in determining the merits of the original claim.

Note

1. See also Emmanuel, "Federal Tax Refund Procedure," 5 *U. of Fla. L. Rev.* 133 (1952); Bickford, *Successful Tax Practice,* Chapter 16 (2d ed. 1952); Goldring, "Claims for Refund," 30 *Taxes* 194 (1952); Zimet, "Tax Refund Claims and the Statute of Limitations," 1 *Tax L. Rev.* 45 (1945), Moser, "Effect of Variations Between Claim for Refund and Trial in Suits for Refund," *12th Annual N.Y.U. Institute on Fed. Taxation* 949 (1954).

Interest is allowed on refunds. See Alexander, "Overpayments of Taxes or Government Investments At Six Per Cent. The Problem of the Allowance of Interest," 7 *Tax L. Rev.* 231 (1952).

For several changes in the computation of interest effected by the 1954 Code, see Senate Report, p. 590.

2. Once a taxpayer gets into the Tax Court, the government may move in its answer or by an amended answer to increase the deficiency claimed in the 90-day letter, even though this involves the introduction of other issues; and even though the taxpayer wins on the deficiency asserted in the 90-day letter, he may lose on the other items and find himself compelled to pay a deficiency larger than was originally claimed. Moreover, the government's answer or amended answer can raise additional issues after the statute of limitations for assessing a further deficiency for the year has run. See *Raskob* v. *Commissioner,* 37 B.T.A. 1283 (1938), where the 90-day letter claimed a deficiency of less than $16,000, and the government's answer increased the deficiency by more than $1,000,000.

In the District Court, however, while a taxpayer cannot recover a refund on one item if the government can establish there was an offsetting error for the same year in an equal or larger amount, there can be no money judgment against him unless the government can still assess a deficiency. Thus, if the taxpayer who has a valid claim for refund waits until just before the expiration of the period of limitations, he may file his claim knowing that there is no longer enough time for the government to assess a deficiency. If there are other items as to which he may have underpaid for the year in question, they can be employed by the government as offsets (if they are resolved against the taxpayer), but they cannot be used for a money judgment against him. This technique might have been effective in *Bush* v. *United States,* 109 F. Supp. 254 (Ct. Cl. 1953), where a claim for refund in an apparently small amount was filed before the statute of limitations had run on the assessment of deficiencies, and where an audit brought on by the refund claim led to the assessment of deficiencies of about $1,600,000.

3. *Finality in the Administrative Process*

(a) *Statutes of limitations*

As will be seen hereinafter, certain administrative procedures are available for finally settling tax liability for a given year, but they are rarely employed. There is also a variety of situations in which the taxpayer can ordinarily assume (without being certain) that his return will not be re-examined. If a return is filed without audit or if an examiner recommends that it be accepted as filed, for example, the taxpayer will rarely hear anything more that year. But only the running of the statute of limitations will supply final protection against re-examinations of the return.

The principal statute of limitations is § 6501(a), providing that the assessment must be made within three years after the return has been filed. No suit for collection of the tax without assessment may be commenced after this period has expired. To the three year period provided by § 6501(a), there are certain exceptions, of which the most important are:

(a) If the taxpayer omitted from gross income more than 25 per cent of the gross income reported on the return, the period for assessment is extended to six years. § 6501(e)(1).

(b) If the taxpayer failed to file a return (even though the omission was innocent) or filed a false or fraudulent return, there is no period of limitations. §§ 6501(c)(1) and (3). This should not be confused with a criminal prosecution, for which the period is either six years (attempting to evade tax, assisting in preparation of false return, willful failure to pay tax or to file return, *etc.*) or three years (certain other offenses). § 6531.

(c) If the taxpayer and Commissioner consent to an extension of the time before its expiration, the period will be extended as agreed. § 6501(c)(4). Form 872 is ordinarily used for this purpose, and will often be proffered to the taxpayer if the Commissioner is in the midst of an audit or if decision on some matter is being held in abeyance pending litigation in another case. If the taxpayer refuses to consent to an extension of the time for assessment, the Bureau may make an assessment or a jeopardy assessment without waiting longer. See Emmanuel, "The Effect of Waivers in Federal Income Tax Cases," 3 *U. of Fla. L. Rev.* 176, 184-91 (1950).

Once a tax has been assessed, the Bureau has six years to collect it by distraint or suit. § 6502(a). See generally, Levin, "Civil Liability and the Statute of Limitations," *12th Annual N.Y.U. Institute on Fed. Taxation* 891 (1954); Burns, "Statute of Limitations in Fraud Cases," *id.* 43.

(b) *Closing agreements*

Note: **Section 7121 of the 1954 Code, relating to closing agreements, is substantially the same as § 3760 of the 1939 Code.**
See Regs. 118, Sec. 39.3760-1.

MIM. 6383
Bureau of Internal Revenue, 1949
49-2 C.B. 100

1. Section 7121 of the Internal Revenue Code authorizes the Commissioner (or any officer or employee of the Bureau of Internal Revenue, including the field service, authorized in writing by the Commissioner) to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period. The section further provides that if the agreement is approved by the Secretary, the Under Secretary, or an Assistant Secretary, within such time as may be stated in the agreement, or later agreed to, the agreement will be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact, (1) the case shall not be reopened as to matters agreed upon or the agreement modified, by any officer, employee, or agent of the United States, and (2) in any suit, action, or proceeding, the agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded.

2. Closing agreements under section 7121 of the Internal Revenue Code may relate to any taxable period ending prior or subsequent to the date of the agreement. With respect to taxable periods ending prior to the date of the agreement, the matter agreed upon may relate to the total tax liability of the taxpayer (Form 866) or it may relate to one or more separate items affecting the tax liability of the taxpayer (Form 906), as, for example, the amount of gross income, deductions for losses, depreciation or depletion, or the year for which an item of income is to be included in gross income or the year for which an item of loss is to be deducted, or the value of property on a specified date. A closing agreement may also be entered into in order to provide a "determination under the income tax laws" as defined in section 1313 of the Code and for the purpose of allowing a deficiency dividend credit under section 547 of the Code. With respect to taxable periods ending subsequent to the date of the agreement on Form 906, the matter agreed upon may relate only to one or more separate items affecting the tax liability of the taxpayer. The following, among others, are examples of the latter type of closing agreement: (1) A taxpayer may sell a portion of his holdings in a particular stock. A closing agreement on Form 906 may be entered into fixing the cost or other legal factor determining the basis for computing gain or loss on such sale, and, at the same time, fixing the cost or other legal factor determining the basis (unless or until the statute is changed to require the use of some other factor to determine basis) of the remaining portion of the stock still held by the taxpayer upon which gain or loss will be computed when the taxpayer sells such stock in a later year; (2) if the taxpayer is undecided whether to sell property or hold it, or as to the price at which to sell it, a closing agreement may be entered into determining the market value of the property as of March 1, 1913, for future taxable periods, prior to the consummation of the sale by the taxpayer. Closing agreements may be executed even though under the agreement the taxpayer is not liable for any tax for the period to which the agreement relates. There may be a series of agreements relating to the tax liability for a single period.

3. A closing agreement will be entered into and submitted for the approval of

the Secretary of the Treasury, the Under Secretary, or an Assistant Secretary, in any case in which (1) there appears to be an advantage in having the case permanently and conclusively closed, such as where, in the settlement of disputed issues, the taxpayer and the Government have made mutual concessions, or (2) where good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is shown that the Government will sustain no disadvantage through consummation of such an agreement, examples of which are:

(a) Estates where the fiduciary desires a closing agreement in order that he may be discharged by the court;

(b) Trusts, or receiverships, where the fiduciary desires a final determination before distribution is made;

(c) Corporations in process of liquidation or dissolution which desire closing agreements in order to wind up their affairs;

(d) Cases where, in connection with the taxpayer's financial affairs, creditors demand authentic evidence of the status of the taxpayer's tax liability;

(e) Cases where taxpayers desire to follow the consistent practice of closing their returns from year to year;

or (3) such action has been determined appropriate under the provisions of § 547 or § 1313 of the Code, or (4) properly executed amended returns have been filed by taxpayers, after the expiration of the period in which assessments might have been made and where no fraud was involved, if the barred deficiency amounts to $500, or more, and payment has been made. No application for a closing agreement will be rejected solely because there is no apparent advantage to the Government.

TAYLOR
PROCEDURES IN EFFECTING CLOSING AGREEMENTS

1951 So. Calif. Tax Inst. 555, 577–80
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Bureau Procedure as to Closing Agreements

Closing agreements are indeed "ponderous things." The Bureau procedure as to their issuance is long and involved and is centralized in Washington. Requests for closing agreements on prospective transactions are first considered in the section of the Income Tax Unit or other Unit which initially considers a request for a ruling in a similar situation. Such section prepares a ruling indicating whether or not the Commissioner will recommend the approval of the requested closing agreement. If the recommendation is favorable, a draft of the closing agreement, together with a supporting memorandum, is also prepared. The matter then goes to the office of the Chief Counsel, where it is considered by a special committee called the Closing Agreement Committee, composed of representatives of the Chief Counsel's Office and of the Income Tax Unit. A closing agreement as to a prospective transaction is then reviewed by the Interpretative Division of the Chief Counsel's Office. It is then referred to the Chief Counsel who recommends to the Commissioner whether or not it should be executed. The Commissioner will then inform the taxpayer of the position of the Bureau, and if the ruling is favorable, both the ruling and a proposed draft of the closing agreement will be sent to the taxpayer. After signature by the taxpayer, the closing agreement is again reviewed in turn by the Income Tax Unit, the Commissioner (who signs

the agreement), the Chief Counsel of the Bureau, the General Counsel of the Treasury, and the Office of the Secretary of the Treasury, where, if it has received the approval of all concerned, it is finally signed by the Secretary, the Under Secretary, or an Assistant Secretary. The appropriate field division is advised as to the execution of a closing agreement and as to the basis thereof.

The Effect of a Closing Agreement

A closing agreement is final and conclusive upon the parties thereto "except upon a showing of fraud or malfeasance or misrepresentation of a material fact." Fraud must be proved by clear and convincing evidence if it is desired to set aside a closing agreement. Evidence creating a "mere suspicion" that a closing agreement was obtained through the taxpayer's fraud will not suffice. " . . . the fraud, malfeasance, or misrepresentation which the statute contemplates must be that of the party claiming under the agreement, and not that of the party attacking it." Hence, a taxpayer, in order to set aside a closing agreement, must demonstrate fraud or misrepresentation by the Government or its agents, and it is insufficient to show fraud or misrepresentation on the part of one of the taxpayer's own officers or employees.

The misrepresentation referred to in the statute requires more than mere error or mistake. Unilateral or mutual mistake of law or of fact is not sufficient of itself to set aside a closing agreement. A closing agreement with respect to a prospective transaction is subject to any change or modification of law enacted subsequent to the date of the agreement, and each closing agreement so provides.

Note

See also Oliphant, "The Administrative Decision in Taxes," 27 *Mich. S.B.J.* 5 (1948), Surrey, "Some Suggested Topics in the Field of Tax Administration," 25 *Wash. U.L.Q.* 399, 423–440 (1940).

While the closing agreement can be a useful technique for protecting the taxpayer against re-examination, it is seldom employed. Only 257 final closing agreement cases were disposed of by the Service in the fiscal year 1952. The purpose of the agreement, finality, itself induces caution in its use; and any procedure that requires action by such exalted officials as the Secretary, Under Secretary, or an Assistant Secretary is bound to be more theoretical than real. In 1950, however, authority to execute Form 866 agreements was delegated to the Commissioner, 52–1 C.B. 151, and in the 1952 reorganization of the Service this authority was in turn delegated to the Assistant District (now Regional) Commissioners, Appellate. This may presage a more common use of the closing agreement. Form 906 agreements continue to be subject to the traditional high level review.

(c) *Compromises*

Note: **Section 7122 of the 1954 Code, relating to compromises, is substantially the same as § 3761 of the 1939 Code.**

GOODRICH AND REDMAN
PROCEDURE BEFORE THE BUREAU OF INTERNAL REVENUE

Committee on Continuing Legal Education of the American Law Institute
2nd edition, 1953, pp 140–43
(Reprinted by Permission)

Offers in compromise are governed by § 3761(a) [§ 7122, 1954 Code] which provides for that procedure as a regularly established device for use in settling dis-

puted tax liability. As a matter of practice, however, except for infrequent use in fraud cases involving potential criminal prosecution, it is used for the most part only where taxpayer is financially unable to satisfy the amount of tax being claimed against him, whether or not he has admitted liability for the claim. In other words, in a number of instances taxpayer can proceed with the ordinary and regular determination of his proper tax liability through the various steps described above. Thereafter it may still be possible to effect payment of that tax so determined through the device of an offer in compromise. This is important because it may well be possible that between the time a matter first arises and the time it is finally settled, taxpayer's financial status conceivably can change considerably, with the result that regardless of his actual tax liability, he may be able to pay only a very small portion of that amount.

The procedure for filing an offer in compromise is a complicated and long-drawn out process. The offer is filed in the first instance with the appropriate Director. Form 656 is used except where the offer calls for installment payments, in that event, Form 656C is to be filed. The offer must be accompanied by a financial statement, Form 433. In many instances, a deposit is sent along with the offer in compromise to show good faith and for the generally good psychological effect it might have on the Bureau officials who will pass on the offer.

The original investigation into the taxpayer's actual ability to pay is made by the Audit Division in the office of the Director with whom the offer is filed. This embraces an analysis of taxpayer's financial statement, as well as investigation in the field, as it were, into taxpayer's living habits, bank accounts and so on. Conferences may be had at this stage with the agent or his group chief or other superior official in the Director's office. If, on the basis of the information thus secured, acceptance is indicated, the offer is passed along to the Appellate Division. If the reviewers feel otherwise, the offer may be tentatively rejected, with indications perhaps that a somewhat higher sum should be offered. The Director has final authority to reject the offer in cases where the tax liability (not the amount of the offer) involved is $5,000 or less; where the amount is larger, the Director's proposal to reject the offer is subject to review by the Appellate Division.

On the basis of its study of the file, the Appellate Division will, if necessary, refer the case back to the field for further investigation. During the course of these negotiations, similar in nature and procedure to negotiations with the Division looking towards settlement of the amount of tax liability, an amended offer may be made which might result in the Division's approval. Of course, the Division may have been satisfied with the action proposed by the Director in the first instance.

If the Division decides to reject an offer in compromise, it has final authority to do so and thereby end the matter. The one limitation on this rule is where the agent had recommended its acceptance. In that event, the Division must first confer with the lower echelon before taking any specific action as far as the taxpayer is concerned.

If the Appellate Division agrees that the offer should be accepted, the Head of the particular district prepares a form letter, for the signature of the Commissioner, addressed to the Secretary of the Treasury. The letter is accompanied by a memorandum to the Commissioner setting forth all aspects of the case. The file is

then transferred to District Counsel for his approval. If that approval is not forthcoming, Division Counsel will prepare a dissent, as it were, which becomes part of the file. The file is then transferred to Washington for review first by Appellate Division headquarters and then by the Commissioner's office. This review occasionally causes return of the case to the Division office in the field for efforts to secure a better offer from the taxpayer. This, in turn, can, in effect, start the entire process all over again.

If the actions proposed by the field are acceptable to the Head of the Appellate Division in Washington and to the Commissioner's office, the Commissioner then approves the contemplated compromise and sends along the file with the form letter recommending acceptance by the Secretary of the Treasury. On its way to the Secretary's office, however, the file passes through the Chief Counsel for approval of the Chief Counsel's Claims Division. At the Secretary's office the proposal receives its final review by an assistant to the General Counsel. It is then finally placed before the appropriate Treasury official for signature.

It is quite clear that this procedure is lengthy and cumbersome; as a result, it is not frequently used. When it is, plans must be made to wait a year, or more, before final approval is received. Notice of rejection generally does not take that long because of the various places along the line where rejection can occur. Efforts have been made in the past and are generally in progress almost all the time to eliminate some of the cumbersome aspects of the procedure and thereby increase the likelihood of some wide-spread use of the offer in compromise. The suggestion has been made that the device be handled in exactly the same fashion as any other tax settlement, and perhaps simultaneously with the determination of liability for tax itself.

Note

During the fiscal year 1952 the Bureau disposed of 3,445 offers in compromise of income, excess profits, estate, and gift taxes, of which 1,134 were accepted and 2,148 rejected or withdrawn. Compromise procedure has been recently modified by Rev. Rul. 117, 53-1 C.B. 498. Accepted compromises were opened to public inspection by T.D. 5927, 52-2 C.B. 298, see IR-Mim. 26, *id.* 299.

See also Tannenbaum, "Compromises Based on Inability to Pay," *10th Annual N.Y.U. Institute on Fed. Taxation* 839 (1952); Paul, Federal Tax Compromises and Prospective Regulations, in his *Selected Studies in Federal Taxation*, Second Series (1938) 53, Kamens and Ancier, "Civil Offers in Compromise," 28 *Taxes* 427 (1950).

(d) Form 870 and other settlements

BOTANY WORSTED MILLS v. UNITED STATES

Supreme Court of the U. S., 1929
278 U.S. 282

Mr. Justice Sanford delivered the opinion of the Court.

The Botany Worsted Mills, a New Jersey corporation engaged in the manufacture of woolen and worsted fabrics, made a return of its net income for the taxable year 1917 under the Revenue Act of 1916 and the War Revenue Act of 1917. By section 12(a) of the Revenue Act it was provided that in ascertaining the net income of a corporation organized in the United States, there should be

deducted from its gross income all "the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties." Under this provision the Mills deducted amounts aggregating $1,565,739.39 paid as compensation to the members of its board of directors, in addition to salaries of $9,000 each. It paid an income tax computed in accordance with this return. Thereafter, in 1920, the Commissioner of Internal Revenue assessed an additional income tax against it. Of this, $450,994.06 was attributable to his disallowance of $783,656.06 of the deduction claimed as compensation paid to the directors, on the ground that the total amount paid as compensation was unreasonable and the remainder of the deduction as allowed represented fair and reasonable compensation. The Mills after paying the additional tax filed a claim for refund of this $450,994.06. The claim was disallowed; and the Mills thereafter, in September, 1924, by a petition in the Court of Claims sought to recover this sum from the United States, with interest—alleging that the disallowance of part of the compensation paid the directors was illegal. After a hearing on the merits the court, upon its findings of fact, dismissed the petition upon the ground that the additional tax was imposed under an agreement of settlement which prevented a recovery. 63 Ct. Cl. 405. And this writ of certiorari was granted.

The first question presented is whether the Mills is precluded from recovering the amount claimed by reason of a settlement.

Section 3229 of the Revised Statutes provides that:

> The Commissioner of Internal Revenue, with the advice, and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal-revenue laws instead of commencing suit thereon; and with the advice and consent of the said Secretary and the recommendation of the Attorney-General, he may compromise any such case after a suit thereon has been commenced. Whenever a compromise is made in any case there shall be placed on file in the office of the Commissioner the opinion of the Solicitor of Internal Revenue, . . . with his reasons therefor, with a statement of the amount of tax assessed, . . . and the amount actually paid in accordance with the terms of the compromise.*

The Government did not claim that there had been a compromise under this statute, but contended in the Court of Claims that, irrespective thereof, an agreement of settlement † had been entered into between the Mills and the Commis-

* This statutory provision, with minor modifications, is now § 7122 of the Code. Closing agreements, now governed by § 7121 of the Code, were not authorized until the Revenue Act of 1921 was enacted, several years after the tax year involved in the case. [Ed.]

† There was no "agreement" in writing. The record contains the following findings on the "settlement" (pp. 18–20):

"After much correspondence and numerous conferences extending over a period of several months in which the plaintiff was represented by its attorney, John Quinn, and by its assistant treasurer, W. J. Helmer, and other parties, and the defendant represented by Sidney Alexander, chief of the special audit section, Bureau of Internal Revenue, and others of his official associates, a compromise was agreed to as to all of the differences. In the said conferences Alexander informed Quinn that in view of the fact that the organization controlled by the Alien Property Custodian had considered the compensation paid to the directors for the year 1918 as being fair and reasonable, the same conclusion 'could be reached upon the part of the Government in considering it a fair and reasonable amount for 1917.' The results of the said conferences were reported by Quinn to the plaintiff's board of directors from time to time during their continuance.

"Thereafter amended returns were prepared and executed by plaintiff's executive officers, based upon the figures as agreed upon in the said conferences, and were filed with the Commissioner of Internal Revenue together with documentary evidence which it was agreed upon at the last conference should be furnished, and the tax so computed, with a slight change not material to this case, was paid by the plaintiff." [Ed.]

sioner under which the Mills had accepted the partial disallowance as to the compensation paid the directors, and had also received concessions as to other disputed items the benefit of which it still enjoyed, and was therefore estopped from seeking a recovery.

As to this matter the findings of fact show that after the Mills had paid the amount of the tax shown by its original return an investigation of its books disclosed to the Commissioner the necessity of making an additional assessment, to be determined by the settlement of questions relating to the compensation (or, as it was termed, bonus) paid to the directors, depreciation charged off on its books, and reserves charged to expenses. After much correspondence and numerous conferences extending over several months between the attorney and assistant treasurer of the Mills and the chief of the special audit section of the Bureau of Internal Revenue and others of his official associates, a compromise was agreed to as to all the differences, by which the amount to be allowed as reasonable compensation to the directors and as depreciation were agreed upon, and the claim as to reserves was allowed. Thereupon the Mills prepared and filed an amended return based upon the figures agreed upon in the conferences, with documentary evidence which it had agreed to furnish; and the additional assessment was made in accordance with this return.

The court, in sustaining the Government's contention, said:

> With the payment of the tax under the circumstances surrounding this case the agreement, which is mentioned in the record as a "gentleman's agreement," became in legal effect an executed contract of settlement;

and that, as the Mills was seeking to recover on account of the particular item which it regarded as unfavorable to its interests, and at the same time hold to the advantage derived from the settlement of other items in dispute involved in the same general settlement, it should not be allowed a recovery.

The Mills contends that the Commissioner had not been given, at the time in question, any authority, either in express terms or by implication, to compromise tax cases except as provided in section 3229; that this statute in granting such authority under specific limitations as to the method to be pursued, negatived his authority to effect a valid and binding agreement in any other way; that as the Government could not have been estopped by the unauthorized transactions of its officials, the Mills likewise could not be estopped thereby; and further, that the findings are insufficient to establish an estoppel.

The Government does not here challenge any of these contentions. In the brief for the United States filed in this Court the Solicitor General states that the question whether such an informal adjustment of taxes as was made in this case is binding on the taxpayer, is submitted for decision in deference to the opinion of the Court of Claims and the importance of the question—but no argument is made in support of the Government's previous contention that the Mills was estopped from questioning the settlement. And, on the contrary, it is stated that—

> Before and since the date of the alleged settlement in this case Congress has evidently proceeded on the theory that no adjustment of a tax controversy between representatives of the Bureau of Internal Revenue and a taxpayer is binding unless made with the formalities and with the approval of the officials prescribed by statute. The authority of officers of the United States to compromise claims on behalf of or against the United States is strictly limited. . . . The statutes which authorize conclusive agreements and settlements to be made in particular ways and with the approval of desig-

nated officers raise the inference that adjustments or settlements made in other ways are not binding.

And further, that

No ground for the United States to claim estoppel is disclosed in the findings.

Independently of these concessions, we are of the opinion that the informal settlement made in this case did not constitute a binding agreement. Section 3229 authorizes the Commissioner of Internal Revenue to compromise tax claims before suit, with the advice and consent of the Secretary of the Treasury, and requires that an opinion of the Solicitor of Internal Revenue setting forth the compromise be filed in the Commissioner's office. Here the attempted settlement was made by subordinate officials in the Bureau of Internal Revenue. And although it may have been ratified by the Commissioner in making the additional assessment based thereon, it does not appear that it was assented to by the Secretary, or that the opinion of the Solicitor was filed in the Commissioner's office.

We think that Congress intended by the statute to prescribe the exclusive method by which tax cases could be compromised, requiring therefor the concurrence of the Commissioner and the Secretary, and prescribing the formality with which, as a matter of public concern, it should be attested in the files of the Commissioner's office; and did not intend to intrust the final settlement of such matters to the informal action of subordinate officials in the Bureau. When a statute limits a thing to be done in a particular mode, it includes the negative of any other mode. *Raleigh & G. Railroad Co.* v. *Reid*, 13 Wall. 269, 270, 20 L. Ed. 570; *Scott* v. *Ford*, 52 Or. 288, 296, 97 P. 99.

It is plain that no compromise is authorized by this statute which is not assented to by the Secretary of the Treasury. *Leach* v. *Nichols* (C.C.A.) 23 F.(2d) 275, 277. For this reason, if for no other, the informal agreement made in this case did not constitute a settlement which in itself was binding upon the Government or the Mills. And, without determining whether such an agreement, though not binding in itself, may when executed become, under some circumstances, binding on the parties by estoppel, it suffices to say that here the findings disclose no adequate ground for any claim of estoppel by the United States.

We therefore conclude that the Mills was not precluded by the settlement from recovering any portion of the tax to which it may otherwise have been entitled. . . .

Note

In *L. Loewy & Son, Inc.* v. *Commissioner*, 31 F.2d 652 (2d Cir. 1929), another "agreement" was held not binding on the Commissioner On an audit of the taxpayer's returns, the examiner had proposed overassessments for 1917 and 1918, and deficiencies for 1919 and 1920, resulting in a net deficiency in tax of $247.41. On being notified in writing of these adjustments, the taxpayer replied: "I accept as correct the above statement of net additional tax liability and agree to its assessment in due course." The amount was thereafter paid. Subsequently the Commissioner determined an additional deficiency in tax for 1920. This deficiency was sustained by the Board of Tax Appeals. The Court of Appeals for the Second Circuit, relying principally on the *Botany Mills* case, held that the "agreement" did not prevent the Commissioner from making an additional assessment. The Court also pointed to the statutory authorization for closing agreements (enacted after the time involved in the *Botany Mills* case), the strict provisions of which had not been complied with, as an additional reason why an informal settlement of tax liability should not bind the Commissioner. Moreover, the Court

rejected the taxpayer's theory that there had been both an account stated and an accord and satisfaction:

> Such a contention is quite out of harmony with the reasoning of *Botany Worsted Mills* v. *United States, supra.* It assumes a compromise of a tax liability without the consent of the Secretary of the Treasury, although a consent is required by Section 3229 of the Revised Statutes, and the Supreme Court says that such statute prescribes the exclusive method of a binding adjustment. (31 F.2d at 653–54)

PAYSON v. COMMISSIONER

U S Court of Appeals, Second Circuit, 1948
166 F.2d 1008

Before SWAN, AUGUSTUS N. HAND, and CLARK, Circuit Judges.

SWAN, Circuit Judge.

This proceeding involves a deficiency in the petitioner's income tax liability for the year 1941. Two questions are presented for decision. The first is whether the Commissioner was precluded from determining the deficiency in suit by reason of the taxpayer having paid a previously determined deficiency for the same year, after signing a waiver of restrictions on the assessment and collection of that deficiency. After an audit of his 1941 return the taxpayer was notified of an additional tax of $6,900.70. In July 1944 he signed Form 870 of the Treasury Department, Internal Revenue Service, which is a "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax;" and thereafter he paid said additional tax with interest thereon. Such a waiver is provided for by section 272(d) [§ 6213(d) of the 1954 Code].[1] After payment of this deficiency the taxpayer was notified of an additional deficiency resulting from disallowance of a capital loss claimed in his return. This item had not been disallowed in the determination of the first deficiency. In contesting the additional deficiency, the taxpayer contended before the Tax Court, and reasserts here, that the Commissioner's acceptance of the waiver and of payment of the first deficiency estops him from assessing and collecting the second. The argument, as we understand it, is that where the United States has received the consideration due it under an agreement it cannot refuse to perform its own obligations thereunder. But the cases relied upon are inapposite because the waiver imposed no obligation on the United States. On the contrary it expressly gave the taxpayer notice that it was not a final closing agreement and did not preclude the assertion of a further deficiency.[2] By his waiver the taxpayer surrendered his right to appeal that particular deficiency to the Tax Court, but not his right to claim a refund of the tax, and in

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[1] "(d) Waiver of restrictions. The taxpayer shall at any time have the right, by a signed notice in writing filed with the Commissioner, to waive the restrictions provided in subsection (a) of this section on the assessment and collection of the whole or any part of the deficiency."

[2] Form 870 contains the following printed matter just below the taxpayer's signature:

"Note.—The execution and filing of this waiver at the address shown in the accompanying letter will expedite the adjustment of your tax liability as indicated above. It is not, however, a final closing agreement under section 3760 of the Internal Revenue Code, and does not, therefore, preclude the assertion of a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due, nor does it extend the statutory period of limitation for refund, assessment, or collection of the tax."

return he obtained relief from the running of interest on the deficiency, as stated in § 292(a) [§ 6601(d), 1954 Code]. The Tax Court rightly held that the claim of estoppel is groundless. . . .

GUGGENHEIM v. UNITED STATES

U. S. Court of Claims, 1948

77 F. Supp. 186, Cert. den. 335 U.S. 908, reh. den. 336 U. S. 911 (1949)

Before JONES, Chief Justice, and HOWELL, MADDEN, WHITAKER, and LITTLETON, Judges.

LITTLETON, Judge.

Plaintiff sues to recover $10,093.11 income tax plus certain interest, alleged to have been overpaid for 1938 and 1939 by reason of the failure of the defendant to allow deductions for certain nontrade and nonbusiness expenses which were not allowable at the time plaintiff's returns were audited but which plaintiff claims are allowable now by reason of Section 121(a)(2) of the Revenue Act of 1942 [§ 212, 1954 Code]. The defense is not only on the merits but also on the ground of a settlement agreement entered into by the parties at the time deficiencies were determined for the two years.

Plaintiff filed returns for 1938 and 1939 which disclosed net income in the respective amounts of $40,509.41 and $87,245.93, and tax liability in the respective amounts of $6,050.36 and $24,103.08. In the return for 1938 plaintiff claimed deductions of $12,959.39 for hurricane loss to landscaped trees, $19,444.10 for insurance premiums paid, and $3,000 for legal fees paid; and in the return for 1939 claimed deductions of $4,552.62 for legal fees paid. After an examination by a revenue agent substantially all of the deductions mentioned were recommended for disallowance with a resulting deficiency for each year. Plaintiff protested the proposed disallowance and thereafter conferences were held with plaintiff's representatives. A further investigation was made by a revenue agent. As a result of these discussions, the representatives of the Commissioner agreed to recommend for allowance a deduction in the amount of $8,000 for the hurricane loss in lieu of the $12,959.39 claimed by plaintiff. Plaintiff abandoned his contention that the other deductions claimed were allowable. The Commissioner's representatives also agreed to make an adjustment in plaintiff's favor on account of certain dividends.* The result reached by the parties was an agreed net income for 1938 of $67,655.02 and for 1939 of $91,297.16.

Shortly thereafter, plaintiff's tax liability was recomputed for 1938 and 1939 on the income agreed to, showing deficiencies for each year. On May 5, 1941, the Commissioner's representative advised plaintiff that "your [plaintiff's] proposal for settlement" of the tax liability on the basis agreed upon had been accepted and enclosed a document, set out in finding 6,† which provided for a waiver of the statutory restrictions on the assessment and collection of the tax and also provided inter alia that upon execution by plaintiff and approval by the Commissioner

> the case shall not be reopened nor shall any claim for refund be filed or prosecuted respecting the taxes for the years above stated [1938 and 1939], in the absence of fraud,

* These adjustments apparently amounted to about $250.00 for 1938 and about $500.00 for 1939. [Ed.]

† The document was Form 870-TS, the terms of which may be found *infra*, pp. 817–8. [Ed.]

malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations.

Plaintiff signed the formal agreement May 6, 1941, and it was formally accepted on behalf of the Commissioner on the same day (findings 7 and 8). The deficiencies agreed upon were paid by plaintiff on June 2, 1941.

On November 19, 1942,‡ after the enactment of the Revenue Act of 1942, which contained in Section 121 thereof provisions for the allowance of certain non-business expenses as deductions [§ 212, 1954 Code] and made such provisions retroactive for the years 1938 and 1939, plaintiff filed claims for refund for those years (findings 10 and 11), claiming that substantially the same deductions, except in the case of the hurricane loss, which had been disallowed by the Commissioner, should now be allowed. On December 29, 1943, the claims were disallowed by the Commissioner on the ground that the execution by plaintiff of the document, set out in finding 6, and its acceptance by the Commissioner precluded the allowance of the claims for refund (finding 12). This suit followed.

While the defendant is now contesting the allowance sought both on the ground of the deductibility of the items in question under Section 121 of the Revenue Act of 1942, and on the finality of the agreement executed by the parties, we find it unnecessary to consider the first defense since we are of the opinion that plaintiff is precluded under the second defense from maintaining suit on these claims. At the time this agreement was made and executed there was a substantial controversy between plaintiff and the Commissioner as to the former's correct tax liability for 1938 and 1939. Prior to the time the document was executed, the Commissioner had disallowed not only the items involved in this suit but also another substantial item. After protest by plaintiff and conferences both in Washington and New York City, and after at least two investigations had been made by a revenue agent, the parties reached an agreement as to plaintiff's correct net income under the law as it then existed. Whether the agreement was reached as a result of a compromise, or as a result of concessions by both parties, is not important. The conclusion is inescapable from the evidence that there was a meeting of minds as to the final disposition of the case. When that occurred, the Commissioner recomputed plaintiff's tax liability and transmitted to plaintiff the settlement document wherein was set out a deficiency for each of the years. In transmitting that document to plaintiff at that time, the Commissioner stated that he was accepting plaintiff's "proposal for settlement," and also referred to the document as an "agreement" when executed by plaintiff and approved on his behalf. In returning the document after execution, plaintiff likewise referred to it as an "agreement." See finding 7.

We are convinced from the facts that the document which plaintiff executed and the Commissioner accepted was not a mere waiver of restrictions on assessment and collection of a deficiency of tax on usual Form 870, as plaintiff seems to urge. That form was used as a starting point but important additions and alterations were made in it to incorporate the full terms of the agreement. This was done "as a basis for closing the case." By that agreement the parties did much more than agree on the amount of plaintiff's tax liability, as is shown by the two paragraphs which were added to the stated form which they used as a vehicle to set up their agreement finally closing the case.

‡ See § 6511(a) for the period of limitations on the filing of a claim for refund. [Ed.]

In language which we think is too clear to be misunderstood and which would be rendered meaningless if plaintiff's interpretation were to prevail, the agreement states:

> If this proposal is accepted by or on behalf of the Commissioner, the case shall not be reopened nor shall any claim for refund be filed or prosecuted respecting the taxes for the years above stated, in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations.

There is no contention that there was any fraud, malfeasance, concealment, misrepresentation, or mistake in calculation. How this could be interpreted other than to preclude plaintiff from filing a claim for refund or prosecuting this suit is difficult to understand.

Plaintiff says, however, that the agreement is lacking in mutuality for the reason that the Commissioner was left free to reopen the case and assess further deficiencies. We do not so interpret the document. It is true, as will be noted from the document set out in finding 6, that on the prescribed Form 870 there was a provision which expressly stated that the execution of the agreement "does not . . . preclude the assertion of a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due," but when the parties prepared and executed the agreement here involved that provision was stricken. A reasonable interpretation of the entire document is that what the parties sought to do was to close the case in such a manner that it could not be reopened either for a refund or for the assessment of deficiencies except in the case of fraud, malfeasance, etc. We see no reason for interpreting the document otherwise. That a closing agreement under Section 3760 [§ 7121 of the 1954 Code] might have been entered into is not conclusive on the question whether the results which the parties desired to accomplish could not as well have been accomplished through the agreement which they here executed.

The case of *Botany Worsted Mills* v. *United States*, 278 U.S. 282, 49 S. Ct. 129, 132, 73 L. Ed. 379, upon which plaintiff relies, involved an agreement of settlement which the Court held did not preclude the reopening of the case upon a claim for refund. However, that case is easily distinguishable from the case at bar. In the *Botany Worsted* case the agreement was informal and oral in character and was agreed to only by subordinate officials in the Internal Revenue Bureau. There was no formal approval by or for the Commissioner. Many of the elements in the formal agreement involved in this case were lacking in that case. Moreover, we do not understand that case to hold, as plaintiff contends, that under no circumstances will a closing agreement be held binding unless executed in accordance with Section 3760 of the Internal Revenue Code (and a prior similar statute). In discussing the finality of such agreements the Court said

> And, without determining whether such an agreement, though not binding in itself, may when executed become, *under some circumstances*, binding on the parties by estoppel, it suffices to say that here the findings disclose no adequate ground for any claim of estoppel by the United States. [Emphasis supplied.]

At the time the agreement in this case was executed the statute had not run on the collection of further deficiencies, but when the claims for refund were filed the statute had run. It would obviously be inequitable to allow the plaintiff to renounce the agreement when the Commissioner cannot be placed in the same

position he was when the agreement was executed. A clear case for the application of the doctrine of equitable estoppel exists and should be applied. *Cf. R. H. Stearns Co.* v. *United States*, 291 U.S. 54, 54 S. Ct. 325, 78 L. Ed. 647.

The same result was reached in *Baldwin* v. *Higgins*, decided by the United States District Court for the Southern District of New York, June 23, 1937 [not officially reported but set out in American Federal Tax Reports, Vol. 19, page 1341] and affirmed by the Circuit Court of Appeals for the Second Circuit, 100 F.2d 405. A similar modified Form 870 was involved though an even stronger case there existed for the taxpayer for the reason that the portion of the form with respect to the assertion of a further deficiency which was stricken in the case at bar was not stricken in that case. In that case the Court stated:

> The waiver and consent agreement (Form 870, Exhibit 'G') is a binding contract and it was accepted and acted upon by the Commissioner. (*R. H. Stearns* v. *United States*, 291 U S. 54, 61, 62, 54 S Ct 325, 78 L. Ed. 647; *Backus* v. *United States*, Ct. Cl., 59 F.2d 242, *Walker* v. *Alamo Foods Co.*, 5 Cir., 16 F.2d 694)

Some support for plaintiff's position is found in *Joyce* v. *Gentsch*, 6 Cir., 141 F.2d 891, 895, where a similar Form 870 was involved and plaintiff was allowed to reopen the case. However, in that case the portion stricken from the form in this case was not stricken, and the Court in its opinion stated· "The right to assess a further deficiency was expressly reserved."

In *Ross* v. *United States*, Ct. Cl., 75 F. Supp. 725, we held that where a taxpayer files a petition with the Tax Court and a judgment thereon becomes final, he cannot thereafter file a claim for refund and obtain the benefit of the retroactive statute with which we are concerned even though the statute has not run on the filing of a claim for refund. In this case instead of filing a petition with the Tax Court, plaintiff waived his right to go to the Tax Court, consented to the assessment of the deficiencies, and in effect entered into an agreement which effected a finality similar to that which would have obtained had he gone to the Tax Court. . . .

Plaintiff is not entitled to recover and the petition is dismissed. It is so ordered.

HOWELL, MADDEN, and WHITAKER, Judges, and JONES, Chief Justice, concur.

Note

1. Form 870, involved in the *Payson* case, may be found *infra*, p. 817. Form 870-TS, considered in the *Guggenheim* case, is a Form 870 with the modifications noted by the court. See *infra*, pp. 817-18. The modifications that produce Form 870-AS (the currently used successor to Form 870-TS) are also set out *infra*, pp. 817-18.

2. What was the basis for the "equitable estoppel" that, in the opinion of the court, distinguished this case from the *Botany Worsted Mills* case? If the hurricane loss should have been totally disallowed, is it too late for the Commissioner to use this item as an offset in the refund action? If setting off the hurricane loss against the § 212 deductions led to a net deficiency, could it be collected by the government? See *supra*, p. 801.

What if (a) the Commissioner in disregard of the "agreement" had assessed an additional tax before the time for doing so had run, or (b) the taxpayer had renounced the agreement in ample time for the Commissioner to assess an additional tax? Since the Service will ordinarily not renounce an agreement on Form 870-AS, should the taxpayer always be bound by it? If not, he obtains the tactical advantage of protection against an additional assessment (because of the Service's policy not to renounce except for fraud, malfeasance, misrepresentation, or important mathematical error), while he

awaits (for example) the outcome of other litigation, the discovery of favorable evidence, or the death of hostile witnesses before deciding whether to allow the matter to languish in the files for the statutory period or to reopen it.

3. A closing agreement is binding "except upon a showing of fraud or malfeasance, or misrepresentation of a material fact." Section 3760. There is no express statutory ground for setting aside a compromise, § 3761, though no doubt the same facts that would nullify a closing agreement would also nullify a compromise. A Form 870-AS agreement, however, by its own terms, can be set aside not only for fraud, malfeasance, or misrepresentation, but also for mathematical error. Does this mean that it is *not* an attempt to obtain the effect of a closing agreement or compromise without the formality prescribed by statute?

4. *Joyce* v. *Gentsch*, cited in the *Guggenheim* case, held that the taxpayer was not bound by a hybrid form: Form 870 was altered to forbid a claim for refund, but the clause stating that execution of the form does not "preclude the assertion of a further deficiency" was not stricken. Because the right to assert a further deficiency was reserved, the Court said: "The waiver agreement was, therefore, entirely lacking in essential mutuality." Does it follow that because the Commissioner may assert a further deficiency (either because of such a reservation or because the agreement is not executed as a closing agreement or a compromise must be) the taxpayer is free to sue for a refund? Is there any reason why he may not waive his right to sue for a refund? In *Steiden Stores, Inc.* v. *Glenn*, 94 F. Supp. 712 (W.D. Ky. 1950), the Court followed *Joyce* v. *Gentsch* rather than the *Guggenheim* case where the taxpayer had executed an instrument that was described by the Court as Form 870, although it was the same as current Form 870-AS, *i.e.*, with no reservation of the right to assert additional deficiencies Should the express reservation in the *Joyce* form be regarded as merely declaratory of the Commissioner's inability to bind himself in any event?

5. In *United States* v. *Goldstein*, 189 F.2d 752 (1st Cir. 1951), it was held that whereas Form 870 stops the running of interest 30 days after it is executed by the taxpayer, Form 870-AS does not do so until 30 days after it has been acted on by the Commissioner. (In that case, about 15 months passed before such action was taken.) The Court argued that Form 870-AS is by its terms an "offer" by the taxpayer, which does not become a "waiver" until action by the Commissioner, whereas Form 870 is itself a "waiver." Section 6601(d) provides that interest shall terminate 30 days after a "waiver." The Court said that if the taxpayer wanted to protect himself against the Commissioner's leisurely manner he could have filed Form 870. Does the taxpayer have the right to file a Form 870 on his own motion whenever he believes that he has underpaid his tax, whether or not the Commissioner has raised the issue or asked for a waiver? See § 6213(d).

6. Now that the power to execute closing agreements has been delegated to lower echelons of the Service (*supra*, p. 805), is it possible that the courts will be less concerned about the difference in solemnity between action by the Secretary of the Treasury on a closing agreement and action by the Appellate Division on a Form 870-AS? Is there any reason of policy why an agreement that on its face binds both parties "in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations" should not do just that? See Griswold, "Finality of Administrative Settlements in Tax Cases," 57 *Harv. L. Rev.* 912 (1944).

7. See generally Ohl, "Implications of Form 870 and Related Tax 'Settlements'," 11 *U. of Pitts. L. Rev.* 173 (1950); Emmanuel, "The Effect of Waivers in Federal Income Tax Cases," 3 *U. of Fla. L. Rev.* 176 (1950); Gutkin, "Informal Federal Tax Settlements and Their Binding Effect," 4 *Tax L. Rev.* 477 (1949); Goodrich and Redman, "Procedure Before the Bureau of Internal Revenue," Committee on Continuing Legal Education 101-106 (2d ed. 1953).

8. Neither the allowance of a refund claim nor its payment bars the subsequent timely assertion of a deficiency. *Burnet* v. *Porter*, 283 U.S. 230 (1931). This is especially important in the case of administrative refunds resulting from an alleged overpayment by

withheld taxes or amounts paid on estimates, where the refund is ordinarily made, as explained *supra*, p. 798, before audit of the return. *Milleg* v. *Commissioner*, 19 T.C. 395 (1952). Moreover, even though it may be too late to assess additional tax, an erroneous refund may be recovered by suit by the United States within two years after it was made or, in the case of a refund induced by fraud or material misrepresentation, within five years. §§ 7405 and 6532(b).

FORM 870

Form 870 (1953)
U. S. TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

(Date Received)

WAIVER OF RESTRICTIONS ON ASSESSMENT AND COLLECTION OF DEFICIENCY IN TAX AND ACCEPTANCE OF OVERASSESSMENT

Pursuant to section 272 (d) of the Internal Revenue Code or corresponding provisions of prior internal revenue laws, the restrictions provided in section 272 (a) of the Internal Revenue Code or corresponding provisions of prior internal revenue laws are hereby waived and consent is given to the assessment and collection of the following deficiencies, together with interest on the tax as provided by law; and the following overassessments are accepted as correct:

DEFICIENCIES

TYPE OF TAX	YEAR ENDED	TAX	PENALTY	TOTAL

OVERASSESSMENTS

TYPE OF TAX	YEAR ENDED	TAX	PENALTY	TOTAL

(Taxpayer)

(Taxpayer)

(Address)

(SEAL) By ______________ (Date)

NOTE.—The execution and filing of this form at the address shown in the accompanying letter will expedite the adjustment of your tax liability as indicated above. It is not, however, a final closing agreement under section 3760 of the Internal Revenue Code, and does not, therefore, preclude the assertion of a deficiency or a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due, nor does it extend the statutory period of limitation for refund, assessment, or collection of the tax.

If executed with respect to a year for which a JOINT RETURN OF A HUSBAND AND WIFE was filed, this form must be signed by both spouses unless one spouse, acting under a power of attorney, signs as agent for the other.

Where the taxpayer is a corporation, the form shall be signed with the corporate name, followed by the signature and title of such officer or officers of the corporation as are empowered to sign for the corporation, in addition to which the seal of the corporation must be affixed.

16—65164-2 U. S. GOVERNMENT PRINTING OFFICE

FORMS 870-TS AND 870-AS

Form 870-TS (now designated Form 870-AS) was based upon Form 870, with modifications that varied from time to time. In what follows below, the Form 870-TS used in the *Guggenheim* case, *supra*, p. 812, is referred to for convenience as "early Form 870-TS," while the term "late Form 870-TS" designates a later modification, identical with Form 870-AS, now in use. Both the early and the late versions commenced with Form 870, but these changes were made in it:

1. The following words in the Note at the bottom of Form 870 are stricken out in both the early and the late Form 870-TS:

and does not, therefore, preclude the assertion of a deficiency or a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due.

2. The following two paragraphs are added on the back of both the early and the late Form 870-TS, the bracketed words appearing only on the early version and the italicized words appearing only on the late version:

This *Offer of* Waiver of Restrictions is subject to acceptance by or on behalf of the Commissioner of Internal Revenue, on the basis of the adjusted liability as hereinabove proposed, and is to take effect as [such only] *a waiver of restrictions then filed with the Commissioner*, from the date said adjusted liability is accepted by or on behalf of the Commissioner as a basis for the closing of the case, and if not thus accepted will have no force or effect.

If this proposal is accepted by or on behalf of the Commissioner, the case shall not be reopened nor shall any claim for refund be filed or prosecuted respecting the taxes for the year(s) above stated, in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations; and the taxpayer also agrees· (1) To make payment of the above deficiency, together, with interest, as provided by law, promptly upon receipt of notice and demand from the Director of Internal Revenue, and not to file an offer in compromise respecting such liability; and (2) upon request of the Commissioner to execute at any time a final closing agreement as to the tax liability, on the foregoing basis, for said year(s) under the provisions of section 3760 of the Internal Revenue Code.

3. On the late version of Form 870-TS, the introductory clause at the top of Form 870 is altered to include the following italicized words:

Pursuant to section 272(d) of the Internal Revenue Code or corresponding provisions of prior internal revenue laws, *the undersigned offers to waive* the restrictions. . . .

In addition, the words "and hereby waives" in the same sentence are omitted.

(e) Taxpayers' rulings

REV. RUL. 54–172

Bureau of Internal Revenue, 1954
54–1 C.B. —

SEC. 2. GENERAL POLICY AND DEFINITIONS.

.01 It is the policy of the Internal Revenue Service to answer inquiries of individuals and organizations, whenever appropriate in the interest of sound tax administration, as to their status for tax purposes and as to the tax effects of their acts or transactions, prior to their filing of returns or reports as required by the

revenue laws. One of the functions of the National Office of the Internal Revenue Service is the issuance of rulings on such matters. District Directors of Internal Revenue apply the statute, regulations and rulings of the National Office in the determination of tax liability and the collection of taxes, and are authorized, as provided in this Revenue Ruling, to issue determination letters within the scope of their functions in answer to taxpayers' inquiries or requests.

.02 The term "ruling" is used to describe a written statement issued by the National Office of the Internal Revenue Service which is an expression of the official interpretation or policy of the office of the Commissioner of Internal Revenue. Rulings are issued by the Commissioner, or under his authority, and are intended to serve the purpose of establishing principles and policies of the Service in the interpretation and application of substantive tax law. Rulings are issued only by the National Office of the Internal Revenue Service. . . .

.03 The term "determination letter" is used to describe a written statement issued by a District Director of Internal Revenue in response to an inquiry by an individual or an organization, and solely by way of application to the facts involved in a particular inquiry or request of the principles and policies previously established by the National Office. Determination letters are issued only where a determination can be made on the basis of clearly established rules as set forth in the statute, Treasury Decisions or Regulations, or rulings, opinions or court decisions published in the Internal Revenue Bulletin. Where such a determination cannot be made (such as where the question presented involves a novel issue) or the matter is excluded from the jurisdiction of a District Director of Internal Revenue by the provisions of this Revenue Ruling, a determination letter will not be issued by the District Director. . . .

SEC. 3. RULINGS ISSUED BY THE NATIONAL OFFICE IN WASHINGTON, D. C.

.01 *In income, profits, estate, and gift tax* matters the National Office will exercise jurisdiction with respect to prospective transactions and with respect to completed transactions affecting returns to be filed, except that it will not ordinarily issue rulings to taxpayers or their representatives in connection with returns to be filed if the identical issue is also involved in a return or returns of the taxpayer already filed for a taxable period or periods with respect to which the statutory period of limitation on assessment or refund of tax has not expired. . . .

SEC. 4. DETERMINATION LETTERS ISSUED BY DISTRICT DIRECTORS OF INTERNAL REVENUE.

.01 *In income, profits, estate, and gift tax* matters District Directors of Internal Revenue are authorized to issue determination letters in response to taxpayers' requests submitted to their offices involving completed transactions only, which affect returns required to be filed in their districts, but only if the question presented is covered specifically by statute, Treasury Decision or Regulations, or specifically by a ruling, opinion, or court decision published in the Internal Revenue Bulletin. Determination letters will not usually be issued with respect to a question which involves an income, profits, estate, or gift tax return or returns to be filed by the taxpayer if the identical question is involved in a return or returns already filed by the taxpayer. District Directors of Internal Revenue may not issue determination letters as to the income, profits, estate, or gift tax consequence

of prospective or proposed transactions, except as provided in paragraph .04 [relating to stock bonus, pension, and profit-sharing plans under § 165(c)] of this section. . . .

.03 Notwithstanding the provisions of paragraphs .01 and .02 of this section, a District Director of Internal Revenue may not issue a determination letter in response to an inquiry, although presenting a question covered specifically by statute, regulations, or a ruling, etc, published in the Internal Revenue Bulletin, where (1) it appears that a similar inquiry from the taxpayer has been directed to the National Office, (2) the determination letter is requested by an industry, trade association, or similar group, or (3) the request involves an industrywide problem....

SEC. 5. DISCRETIONARY AUTHORITY TO ISSUE RULINGS AND DETERMINATION LETTERS.

.01 Except as provided in paragraph .02 of this section, the Internal Revenue Service has discretionary authority to issue determination letters or rulings (or to approve closing agreements pursuant to section 3760 [§ 7121 of the 1954 Code]. That discretion will be exercised in the light of all relevant circumstances, including the business or other reasons motivating the transaction, and with a view to issuing determination letters or rulings (or approving closing agreements) only to the extent consistent with a wise administration of the revenue system.

.02 Rulings will be made in the National Office on prospective transactions where the law or regulations provide for a determination of the effect of a proposed transaction for tax purposes, as in the case of a transfer coming under the provisions of section 1250 and section 1251 [§§ 1491 and 1492, 1954 Code], or an exchange coming under the provisions of section 112(i) [§ 367, 1954 Code].

SEC. 6. QUESTIONS ON WHICH NO RULING OR DETERMINATION LETTER WILL BE ISSUED.

In addition to the other situations described herein, rulings or determination letters ordinarily will not be issued in connection with income, profits, estate, and gift tax matters where the determination requested is primarily one of fact, *e.g.*, (1) market value of property, (2) whether compensation is reasonable in amount, (3) whether a transfer is one in contemplation of death, (4) whether retention of earnings and profits by a corporation is for the purpose of avoiding surtax on its shareholders, or (5) whether a transfer or acquisition is within section 15(c) or section 129 [§§ 1731 and 269, 1954 Code]. . . .

SEC. 10. WITHDRAWAL OF REQUESTS.

The taxpayer's request for a ruling or a determination letter may be withdrawn at any time prior to the signing of the letter of reply. The withdrawal of the request will not prevent the National Office from furnishing its views to the District Director in whose office the return has been or will be filed. Neither shall such withdrawal prevent a District Director of Internal Revenue from considering the information submitted in a subsequent audit or examination of the taxpayer's return. Even though a request is withdrawn all correspondence and exhibits shall be retained in the files of the Internal Revenue Service and may not be returned to the taxpayer.

SEC. 11. ORAL ADVICE TO TAXPAYERS.

It is the policy of the Service not to issue rulings or determination letters upon oral request. For reasons of sound administration, oral opinions or advice given to taxpayers by employees or officers of the Internal Revenue Service are considered as aids to taxpayers only.

SEC. 12. EFFECT OF RULINGS.

.01 Generally no statement by an official of the Internal Revenue Service, other than a closing agreement under section 3760 of the Internal Revenue Code, is final and conclusive upon the Internal Revenue Service. However, see paragraphs .05, [and] .06 of this section. . . .

.05 A ruling found to be in error or no longer in accord with the position of the Internal Revenue Service may be modified or revoked. Modification or revocation may be effected by a notice to the taxpayer to whom the ruling originally was issued, or by a ruling or other statement published in the Internal Revenue Bulletin. However, it is the general policy of the Internal Revenue Service to limit the revocation or modification of a ruling issued to or with respect to a particular taxpayer to a prospective application only, (a) if there has been no misstatement or omission of material facts, (b) the facts subsequently developed are not materially different from the facts on which the ruling was based, (c) there has been no change in the applicable law, and (d) such taxpayer acted in good faith in reliance upon such ruling and a retroactive revocation would be to his detriment.

.06 With respect to rulings published in the Internal Revenue Bulletin, it is the general policy of the Service that taxpayers may rely upon such rulings in determining the rule applicable to their own transactions and need not request a specific ruling applying the principles of the published ruling to the facts of the taxpayer's particular case where otherwise applicable. See, however, .08 of this section. In the event of revocation or modification of a ruling published in the Internal Revenue Bulletin, it is the general practice of the Service to make such revocation or modification prospective only. . . .

.08 Since each ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, revenue officials and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. Furthermore, Service personnel and others concerned should, in this connection, consider the effect of subsequent legislation, regulations, court decisions, and rulings.

SEC. 13. EFFECT OF DETERMINATION LETTERS.

A determination letter issued by a District Director, in accordance with this Revenue Ruling, shall be given the same effect upon examination of the return of the taxpayer to whom the determination letter was issued as is described in section 12, in the case of a ruling issued to a taxpayer, except that reference to the National Office is not necessary where upon the examination of the return it is the opinion of the District Director that a conclusion contrary to that expressed in the determination letter is indicated. A District Director is not authorized to limit the revocation of a determination letter to a prospective application only, but

may refer the matter to the National Office for exercise by the Commissioner, or his delegate, of the authority so to limit the revocation.

Note

1. During the fiscal year 1952, more than 40,000 rulings were issued by the Service to taxpayers and field offices of the Service, according to the Commissioner's Annual Report. (The rulings to field offices, see Mim. 6293, 48–2 C B. 59, IR-Mim. No. 18, Aug. 15, 1952, on which the taxpayer is entitled to file a brief and, in the event of a proposed adverse ruling, to be heard, are not separately totalled.) Of 53,000 income tax rulings made during 1949, 13,000 related to changes in accounting periods, 17,000 to exempt organization claims, and 15,000 to gross income and deductions, capital gains and losses, etc. Kriegh, "The Operation of the Taxpayers' Rulings Section," *10th Annual N.Y.U. Inst. on Fed. Taxation* 663, 669 (1952). See also Richmond, "How and When to Obtain Bureau Rulings," 28 *Taxes* 45 (1950); Wenchel, "Taxpayers' Rulings," 5 *Tax L. Rev.* 105 (1950).

2. In *Couzens* v. *Commissioner*, 11 B.T.A. 1040 (1928), a leading case, the Board of Tax Appeals held that a ruling of the kind here involved does not bind the Commissioner even though the taxpayer acts in reliance on it. On going into the merits, however, the Board made a determination more favorable to the taxpayer (on a question of valuation) than the ruling by which he insisted the government was bound. In a suit by another taxpayer involving the same ruling, the Commissioner was held to be bound by the ruling, or at least by an assessment made pursuant to it. *Woodworth* v *Kales*, 26 F.2d 178 (6th Cir. 1928). Having obtained a refund on the theory that the government was bound by the ruling, however, this taxpayer brought a second suit to recover part of the tax originally paid pursuant to the ruling on the ground that the ruling was too favorable to the government. This suit was also successful *United States* v. *Kales*, 314 U S. 186 (1941). See also *H.S.D. Co.* v. *Kavanaugh*, 191 F 2d 831 (6th Cir. 1951), Manning, "The Application of the Doctrine of Estoppel Against the Government in Federal Tax Cases" 30 *No. Car. L. Rev.* 356, 367–80 (1952) See Newman, "Should Official Advice Be Reliable?—Proposals As to Estoppel and Related Doctrines in Administrative Law," 53 *Col. L. Rev.* 374 (1953).

Whether the government is bound or not, however, a ruling is almost never revoked retroactively as to the taxpayer to whom it was issued, unless the facts were not as represented to the Service. See, for example, *So. Md. Agricultural Fair Assoc.* v. *Commissioner*, 40 B T.A. 549 (1939), where a ruling was revoked and taxes together with penalties for failing to file returns were assessed for a fifteen year period. The ruling had advised the taxpayer that it was an organization exempt under § 501(c)(5), which would have relieved it of the necessity of filing returns. The Commissioner, in revoking the ruling, stated that the corporation's officers "since 1921 have been making distributions to stockholders contrary to the basis on which the exemption was predicated, and must reasonably have known that the ruling of January 18, 1924, was not based upon a full knowledge of the facts." 40 B.T.A. at 550. The Board of Tax Appeals held that the (admittedly erroneous) ruling did not excuse the failure to file returns, so that for all past years the taxpayer was liable for both the tax and the penalty for failure to file a return

Automobile Club of Michigan v. *Commissioner*, 20 T. C. 145 (1953), involved deficiencies for the years 1943–47, assessed against an organization that the Commissioner had ruled in 1934 and 1938 was entitled to exemption under § 501(c)(7). These rulings were reconsidered and revoked in 1945; apparently there had been no misstatement or misunderstanding of the facts when the earlier rulings were issued. The deficiencies were upheld.

3. Until 1953, it was the Service's practice to publish only a small selection of its rulings to taxpayers; a few more became public information because publicized by the taxpayers themselves or their advisers. In 1952, the report of the Subcommittee on

Administration of the Internal Revenue Laws of the House Committee on Ways and Means (better known as the "King Committee") stated (p. 30):

> Much information supplied by taxpayers to the Bureau of Internal Revenue is kept confidential to avoid possible embarrassment or competitive disadvantage to the taxpayer. Consistent with this laudable policy, however, the Bureau should make public as many as possible of its administrative decisions. Their availability to public scrutiny should serve as a deterrent to favoritism and enable the public to satisfy itself as to the impartiality of tax administration. The Bureau recently opened to the public its offer-in-compromise files,* and also the files of the Alcohol and Tobacco Tax Division relative to issuance of basic permits. At the instance of the subcommittee, the Bureau has adopted a new policy of publishing in permanent form all decisions and rulings involving points of law upon which the Bureau will thereafter rely as precedents.

The Service has announced that all rulings to taxpayers or their representatives and communications to its field offices involving "substantive tax law, procedures affecting taxpayers' rights or duties or industry regulation" "will be deemed to be of a character potentially publishable" (a phrase that seems to mean "will be published") with the following exceptions.

> (a) those involving questions specifically and clearly covered by statute or regulations;
>
> (b) those involving questions specifically covered by rulings, opinions, or court decisions previously published in the Bulletin;
>
> (c) those dealing with issues upon which court action is pending and publication would be prejudicial to the best interest of the Government;
>
> (d) those in which the facts involved are so unique or specific that the issue is not likely to arise again;
>
> (e) those which constitute determinations of fact rather than interpretations of law; . . .
>
> (h) those dealing with secret formulae or business practices,
>
> (i) those dealing with informers and informers' rewards; or
>
> (j) those which in the interest of a wise administration of the Revenue Service should not be published, but only if a memorandum stating the reasons therefor is attached to the file and the Commissioner approves the determination of nonpublication. (Rev. Rul. 2, 53-1 C.B. 484; Rev. Rul 212, 53-2 C.B. 449.)

4. This increase in published rulings will make more acute a problem already of significant proportions: since the Bureau has a policy of adhering to a ruling with respect to the taxpayer himself, should it not also be chary of revoking it as to other taxpayers who may have relied on it as much as the taxpayer who requested it? See § 10.06 of Rev. Rul. 54-172, *supra*, p. 818. But the more solicitous the Bureau is of possible reliance on a ruling by other taxpayers, the more cautious it may be in issuing rulings; and since liberalizing the criteria for publication will increase the circle of taxpayers whose possible reliance the Bureau must take account of, there may be a decline in the use of this device for preventing or settling tax disputes.

In this connection, it might be noted that Rev. Rul. 2, *supra*, provides that the Service's standards for determining what communications are to be referred to the Chief Counsel for review "will continue in effect," but that in applying these standards

> officials having responsibility for issuing such communications will give consideration to the added importance which may attach to such communication if published, especially with the view that rulings which may be cited as establishing legal principles should be so reviewed before issuance.

* T.D. 5927, 52-2 C.B. 298; IR-Min. 26, *id.* 299. [Ed.]

STOCKSTROM v. COMMISSIONER

U. S. Court of Appeals, D. of C. Circuit, 1951
190 F.2d 283

[In 1936 Louis Stockstrom made certain gifts in trust. At that time, in computing the donor's liability for a gift tax, a $5,000 exclusion (now only $3,000) was available for gifts other than gifts "of future interests." Section 1003(b)(1).* Because the Commissioner then took the position that *all* gifts in trust were gifts "of future interests," Mr. Stockstrom filed a return and paid a gift tax. In 1937, it was held in several suits brought by other taxpayers that a gift in trust is not a gift "of future interests" if the trustee gets a present interest. The Commissioner acquiesced in one of these decisions. Thereupon Mr. Stockstrom filed a claim for, and received, a refund of his 1936 tax. In 1937 he made further gifts in trust, claiming the $5,000 exclusion in accordance with the Bureau's position, and paid a tax on the excess. This return was examined and a small deficiency was assessed; the exclusions were not disturbed. In 1938 he again made gifts in trust, filing no return because the amounts did not exceed the exclusions.

[In 1941, a revenue agent who was examining Mr. Stockstrom's income tax returns learned of the 1938 gifts. At a conference, the head of the Bureau's St. Louis estate and gift tax section told the agent and Mr. Stockstrom's representative that if a gift tax return had been filed for 1938, no tax would have been due. (If no tax was due, because the taxpayer was entitled to the exclusions, no return was required.) In the same year, 1941, the Supreme Court decided *United States* v. *Pelzer*, 312 U.S. 399, holding in effect that in the case of gifts in trust, the determination of whether a gift is of a future interest is to be made by looking to the interest of the *beneficiary*, not to the interest of the trustee. In 1948, after Mr. Stockstrom's death, the Commissioner asserted a gift tax deficiency against his estate for the 1938 gifts, based on the theory that the gifts were, as to the beneficiaries of the trusts, gifts "of future interests," so that no exclusion was allowable.]

Before Clark, Wilbur K. Miller and Prettyman, Circuit Judges.

Wilbur K. Miller, Circuit Judge.

. . . The question presented by this appeal is not, in our view, whether the Stockstrom declarations of trust gave the beneficiaries a present or a future interest in gifts thereunder. Even if it be assumed that these gifts were of future interests, it does not follow that the Commissioner had the power to assess a tax in the circumstances disclosed here. He had ruled in 1938 pursuant to judicial interpretation that a tax return was not required. He affirmed that ruling in 1941 and then waited until 1948 to claim that a tax was due. The question is whether the Commissioner was barred from asserting tax liability by limitation, waiver or estoppel, or by the principle that one may not found a claim upon an omission which he himself induced.

It is provided by I.R.C. § 1016 † that gift taxes shall be assessed within three years after the return was filed, except that (b) "(1) In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be

* See first sentence of § 2503(b), 1954 Code. [Ed.]

† §§ 6501(a), (c)(1), and (c)(3) 1954 Code. [Ed.]

assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time." There is thus no period of limitation concerning the power to assess a tax when the taxpayer has failed to file a return.

Stockstrom did not physically file a return for 1938, as we have seen. The question is, however, did he fail to file a return within the meaning of the limiting statute? Or, to put it another way, may the Commissioner in the circumstances of this case rely upon the failure to physically file a return as destroying the period of limitation? As the Court of Appeals for the Second Circuit said in *Balkan National Insurance Co.* v. *Commissioner of Internal Revenue*, 1939, 101 F.2d 75, 77: "This section clearly presupposes that the taxpayer was under a duty to file a return and has failed to perform it." The court also said in that case, 101 F.2d at page 78:

While literally there has been "a failure to file a return," that phrase as used in section 278(a) cannot reasonably be interpreted to include a failure caused by the Government itself through seizure of the taxpayer's records. The obvious purpose of the section was to give the revenue officials unlimited time to assess and collect taxes in cases where the necessary data for determining the amount of the tax was lacking because of the taxpayer's fault in failing to supply it in the form of a return. The section should not be construed to cover a case where the United States has obtained the necessary data by seizure of the taxpayer's books, and has made it impossible for him to file a return by denying him access to them.

The court stated that in *Stearns Company* v. *United States*, 1933, 291 U.S. 54, 62, 54 S. Ct. 325, 328, 78 L. Ed. 647, the Supreme Court approved the principle that "A suit may not be built on an omission induced by him who sues," and added " . . There the principle was applied to prevent a taxpayer from relying on the statute of limitations. We believe it is equally applicable to prevent the United States from avoiding the statute."

It has already been made to appear that Stockstrom's failure to file a return for 1938 was due to the Commissioner's ruling, made in 1938 and reaffirmed as late as 1941, that none was required of him. The Commissioner therefore induced the omission which he now relies upon as giving him unlimited time within which to assess a tax. The law as to such a situation has long been established.

The Supreme Court said in *Swain* v. *Seamens*, 1869, 9 Wall. 254, 76 U.S. 254, 274, 19 L. Ed. 554: "Where a person tacitly encourages an act to be done, he cannot afterwards exercise his legal right in opposition to such consent, if his conduct or acts of encouragement induced the other party to change his position, so that he will be pecuniarily prejudiced by the assertion of such adversary claims." The *Swain* case was one between private persons, but the same principle was later held to bind the United States: in *United States* v. *Peck*, 1880, 102 U.S. 64, 26 L. Ed. 46, the Supreme Court cited with approval the following sentence written by a New York judge· ". . . 'It is a sound principle that he who prevents a thing being done shall not avail himself of the non-performance he has occasioned.' "

The principle was restated in expanded form by Mr. Justice Cardozo in *Stearns Company* v. *United States*, *supra* 291 U.S. at pages 61 and 62, 54 S. Ct. at pages 328, 78 L. Ed. 647:

The applicable principle is fundamental and unquestioned. "He who prevents a thing from being done may not avail himself of the non-performance which he has himself occasioned, for the law says to him, in effect: 'This is your own act and therefore you are not damnified.' " *Dolan* v. *Rodgers*, 149 N.Y. 489, 491, 44 N.E 167; and *Imperator*

Realty Co. v. *Tull*, 228 N.Y. 447, 457, 127 N.E. 263; quoting *West* v. *Blakeway*, 2 Man. & G. 828, 839 [729, 751]. Sometimes the resulting disability has been characterized as an estoppel, sometimes as a waiver. The label counts for little. Enough for present purposes that the disability has its roots in a principle more nearly ultimate than either waiver or estoppel, the principle that no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong. *Imperator Realty Co.* v. *Tull, supra.* A suit may not be built on an omission induced by him who sues. . . .

We conclude that Stockstrom's failure to file a return for 1938 was not the sort of failure contemplated by § 1016 of the Internal Revenue Code. In 1941 the Commissioner, who already had copies of the trust agreements, obtained from Stockstrom's books the facts and figures concerning the 1938 gifts. If he later decided, in view of *Helvering* v. *Hutchings*, that tax liability existed, he could have made a return for the taxpayer; indeed, it was the duty of the Commissioner's subordinate, the collector, to do so, I.R.C. § 3612.‡ This could and should have been done promptly, as performance of the duty ought not to have been postponed for years in order to prevent the statute of limitations from running.

As the Supreme Court said in *Helvering* v. *Griffiths*, 1943, 318 U. S. 371, 402, 63 S. Ct. 636, 653, 87 L. Ed. 843, in somewhat similar circumstances: "It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government."

It has been well said that the government should always be a gentleman. Taxpayers expect, and are entitled to receive, ordinary fair play from tax officials. We regard as unconscionable the Commissioner's claim of authority to assess a tax in 1948 because of Stockstrom's failure to file a return for 1938, when the Commissioner himself was responsible for that failure.

Reversed.

PRETTYMAN, Circuit Judge (*dissenting*).

I reluctantly dissent from the judgment of my brethren in this case. I wish the law were as they find it to be, because it is my belief that the Government ought to set a high standard in its dealings and relationships with citizens and that the word of a duly authorized Government agent, acting within the scope of his authority, ought to be as good as a Government bond. But unfortunately, as I see it, a long line of cases almost without exception, beginning with the *Couzens* case in 1928 [1] and running down through *Schafer* v. *Helvering* [2] and beyond, establish the law otherwise. In the *Schafer* case, Judge Groner, writing for this court, said that wrongs between man and man which shock the conscience cannot affect the right of the sovereign to the full measure of a statute. "Whoever deals with the government," he wrote, "does so with notice that no agent can, by neglect or acquiescence, commit it to an erroneous interpretation of the law." Many cases on the point are collected in Merten's *Law of Federal Income Taxation* (1948 rev. ed.) at Sections 60.13–60.18.

I do not see that a revenue agent's statement to a taxpayer that the statute did not require a return to be filed is different from any statement by such an agent upon any question of statutory interpretation. And the Commisioner's about-face

[1] James Couzens, 11 B.T.A. 1040.

[2] 1936, 65 App D.C. 292, 83 F.2d 317, affirmed, 1936, 299 U S 171, 57 S. Ct 148, 81 L. Ed 101

‡ § 6020(b), 1954 Code [Ed.]

on the question of law here involved is not different from his change of mind on other points upon other occasions. The established rule is that in contemplation of law he was, under such circumstances, wrong the first time and the Government is not bound by his error.

I repeat that I wish the law were as the opinion of the court in this case holds it to be, but I am convinced that it is not.

Note

The administrative action upon which the donor relied consisted of (a) an announced "acquiescence" in a decision of the Board of Tax Appeals, 38-1 C.B. 32, withdrawing a previous non-acquiescence, and (b) the statements of the St. Louis Bureau official. "Acquiescence" is stated to mean that the decision "should be relied upon by officers and employees of the Bureau of Internal Revenue as precedents in the disposition of other cases before the Bureau." 38-1 C.B. iv.

If a taxpayer is advised by an official of the Bureau that an item is not taxable, must it be disregarded in determining whether he understated his gross income by more than 25 per cent so as to bring into play the five year period for assessment under § 6501(e)? If the deficiency had been assessed in the *Stockstrom* case during the statutory period, would interest thereon have been excused? If the taxpayer would not have made the gifts (or would have made them in a different, and tax-free, form) but for the erroneous advice, would he have had a defense to a timely deficiency? If the advice had come from an eminent tax adviser rather than from an underpaid Bureau employee, would the taxpayer's failure to file returns have been excused?

Section B. Collection of the Tax

All but a small fraction of all taxes are paid voluntarily (not necessarily willingly) by the taxpayer. Even the taxpayer who disputes liability, if he does not go to the Tax Court, ordinarily pays when the tax is assessed (or before), suing thereafter for a refund. And most taxpayers who litigate in the Tax Court pay promptly if they lose.

But sometimes it is necessary for the government to compel payment, and when this occasion arises, it has a variety of weapons. The most drastic is distraint—seizure and sale of personal and real property, pursuant to § § 6331(a) and (b).*

* See *Bull v. United States*, 295 U.S. 247 (1935):

"A tax is an exaction by the sovereign, and necessarily the sovereign has an enforceable claim against every one within the taxable class for the amount lawfully due from him The statute prescribes the rules of taxation. Some machinery must be provided for applying the rule to the facts in each taxpayer's case, in order to ascertain the amount due. The chosen instrumentality for the purpose is an administrative agency whose action is called an assessment The assessment may be a valuation of property subject to taxation, which valuation is to be multiplied by the statutory rate to ascertain the amount of tax. Or it may include the calculation and fix the amount of tax payable, and assessments of federal estate and income taxes are of this type Once the tax is assessed, the taxpayer will owe the sovereign the amount when the date fixed by law for payment arrives Default in meeting the obligation calls for some procedure whereby payment can be enforced. The statute might remit the government to an action at law wherein the taxpayer could offer such defense as he had. A judgment against him might be collected by the levy of an execution. But taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection. The assessment is given the force of a judgment, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt

"In recognition of the fact that erroneous determinations and assessments will inevitably occur, the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some

See *United States* v. *Manufacturers Trust Co.*, 198 F.2d 366 (2d Cir. 1952); *United States* v. *Metropolitan Life Ins. Co.*, 130 F.2d 149 (2d Cir. 1942); *United States* v. *Prudential Insurance Co.*, 54 F. Supp. 664 (E.D. Pa. 1944); Note, Federal Tax Distraint on Life Insurance, 45 *Yale L.J.* 945 (1936); Gilfeather, "The Commissioner's Collection Apparatus," *12th Annual N.Y.U. Institute on Fed. Taxation* 975 (1954), Brewster, "Distraint Under the Federal Revenue Laws," (1937). The federal statute has its own set of exemptions (clothing and school books "necessary" for the taxpayer and his family; up to $250 worth of tools needed in the taxpayer's occupation; and, if the taxpayer is head of a family, up to $500 worth of fuel, furniture, personal effects, livestock, "arms for personal use," *etc.*), and state exemptions are not binding. Section 6334(a); see *Jones* v. *Kemp*, 144 F.2d 478 (10th Cir. 1944). During the fiscal year 1952, about $330,000,000 of income taxes was collected by distraint.

In lieu of distraint, the government may proceed by suit, either in a federal district court (see 28 U.S.C. 1396 for venue) or in a state court. See Anderson, "Federal Tax Suits in State Courts," 26 *Taxes* 1144 (1948), disputing the propriety of state court actions. The government is also provided with a tax lien, which can be enforced as an alternative method of collecting the tax. Sections 6231 and 7403. The priority of federal tax claims and tax liens is a very troubled subject. See generally Anderson, "Federal Tax Liens—Their Nature and Priority," 41 *Calif. L. Rev.* 241 (1953); Reid, "Tax Liens, Their Operation and Effect," *9th Annual N.Y.U. Inst. on Fed. Taxation* 563 (1951), Feigenbaum, "*The Bankruptcy Triangle: Creditor-Debtor-Commissioner*," 30 *Taxes* 448 (1952); *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361 (1953); Kennedy, "The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien," 63 *Yale L.J.* 905 (1954).

1. *Injunctions against Collection*

Note: Section 7421 of the 1954 Code, relating to injunctions against assessment and collection of tax, is substantially the same as § 3653 of the 1939 Code.

STURGEON v. SCHUSTER

U. S. Court of Appeals, Tenth Circuit, 1947

158 F.2d 811

Before BRATTON, HUXMAN, and MURRAH, Circuit Judges.

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stages to have mistakes rectified. Often an administrative hearing is afforded before the assessment becomes final; or administrative machinery is provided whereby an erroneous collection may be refunded, in some instances both administrative relief and redress by an action against the sovereign in one of its courts are permitted methods of restitution of excessive or illegal exaction. Thus, the usual procedure for the recovery of debts is reversed in the field of taxation. Payment precedes defense, and the burden of proof, normally on the claimant, is shifted to the taxpayer. The assessment supersedes the pleading, proof, and judgment necessary in an action at law, and has the force of such a judgment. The ordinary defendant stands in judgment only after a hearing. The taxpayer often is afforded his hearing after judgment and after payment, and his only redress for unjust administrative action is the right to claim restitution." 295 U S. at 260.

For historical background, see Tresolini, "Administrative Tax Enforcement: Legal Concepts," 27 *Temple L.Q.* 8 (1953).

BRATTON, Circuit Judge.

During the years 1937 to 1941, both inclusive, John O. Schuster was engaged in business in Oklahoma City, Oklahoma, operating part of the time under one trade name and part under another. He regularly filed annual income tax returns for those years; in 1943, he filed amended returns; and he paid the income taxes reflected by the returns. Thereafter, a deficiency assessment was made. Without admitting that any additional taxes were due but claiming that all taxes had been paid in full, the taxpayer deposited with the Collector a sum much less in amount than the deficiency assessment to be used in the payment of any additional taxes that might be finally determined to be due. Claims for refunds were filed. About three months after the filing of the claims and without any formal action having been taken on such claims, the taxpayer filed this action against the Collector. It was alleged in the complaint that all taxes had been paid; that the deficiency was erroneous, arbitrary, and illegal; that the taxpayer was unable to pay the amount of the deficiency; that the Collector unless restrained would levy upon the business of the taxpayer and dispose of it at forced sale for payment of the assessment; that the business had developed a valuable good will; that the attempted sale would destroy the business; and that the taxpayer would suffer irreparable injury for which he had no plain, speedy, and adequate remedy at law. The prayer was that the court issue a temporary restraining order, and a permanent injunction; and further that upon a hearing the court determine the excess in taxes paid and order the amount thereof refunded to him. Based upon the statements of fact made by the attorneys in open court, the court entered an order granting a temporary injunction restraining the Collector from attempting to collect the additional taxes embraced within the deficiency assessment and from interfering with the taxpayer in the operation and conduct of his business; and the court enjoined the taxpayer during the pendency of the action from selling or disposing of the business, or the assets and property of it, except in the usual and ordinary course of business. The appeal is from that part of the injunction restraniing the collection of the taxes.

Section 3653 [§ 7421 of the 1954 Code] provides that, except as provided in sections 272(a), 871(a), and 1012(a), no suit to restrain the assessment or collection of any tax shall be maintained in any court. The statute is broad in sweep; and a complaint, as here, alleging that all taxes due have been paid, that the deficiency assessment is erroneous, arbitrary, and illegal, that the taxpayer is unable to pay the additional assessment, and that the threatened sale of the business will subject the taxpayer to irreparable injury for which he has no plain, speedy, and adequate remedy at law, without more, fails to state a cause of action which warrants the issuance of an injunction restraining the collectors from enforcing payment of the tax. . . .

The statute does not withhold from a court of equity jurisdiction in a case where the complainant shows that in addition to the illegality of the tax, special and extraordinary circumstances are present sufficient to bring the case within some acknowledged head of equity jurisprudence. *Miller* v. *Standard Nut Margarine Co.*, 284 U.S. 498, 52 S. Ct. 260, 76 L. Ed. 422; *Allen* v. *Regents*, 304 U.S. 439, 58 S. Ct. 980, 82 L. Ed. 1448, *Burke* v. *Mingori*, 10 Cir., 128 F.2d 996, cert. den. *Mingori* v. *Broderick*, 317 U.S. 662. But no such circumstances are presented here.

Two separate remedies are available to a taxpayer when a deficiency assessment is made against him which he challenges. One is to pay the tax, file a claim for refund, and on rejection of the claim sue at law for recovery. The other is to seek redetermination by the Tax Court, with the right of review in the Circuit Court of Appeals, and the further right to apply to the Supreme Court for certiorari. If the taxpayer does not desire to pay the tax and sue for its recovery, or is unable to pay it, he may seek redetermination. In that event no distraint may be prosecuted until the decision of the Tax Court becomes final; and in the event distraint is improvidently initiated during that time, it may be enjoined in the proper court, Int.Rev.Code, § 272. But this taxpayer did not avail himself of either remedy. Instead, without the presence of any extraordinary circumstances taking the case beyond the reach of section 3653, *supra*, he sought injunctive relief on general principles of equity. Such an action cannot be maintained. . . .

The order is reversed insofar as it grants a temporary injunction restraining the collector, the temporary injunction is vacated, and the cause is remanded.

Note

1. What "extraordinary circumstances" will evoke the aid of equity to restrain collection? In *Allen* v. *Regents of the University of Georgia*, 304 U.S. 439 (1938), a suit in equity was held appropriate where the federal government was demanding that the University of Georgia, a state institution, collect the federal admissions tax on athletic tickets. The Supreme Court said, in a passage that will be of little use to private taxpayers:

> If the tax, the collection of which was threatened, constituted an inadmissible burden upon a governmental activity of the State, the circumstances disclosed render the cause one of equitable cognizance and take it out of the prohibition of R.S. 3224 [now I.R.C. 7421(a)]. . . .
>
> The dispute as to the propriety of a suit in equity must be resolved in the light of the nature of the controversy. The respondent in good faith believes that an unconstitutional burden is laid directly upon its transactions in the sale of licenses to witness athletic exhibitions conducted under authority of the State and for an essential governmental purpose. The State is entitled to have a determination of the question whether such burden is imposed by the statute as construed and applied. It is not bound to subject its public officers and their subordinates to pains and penalties criminal and civil in order to have this question settled, if no part of the sum collected was a tax, and if the assessment was in truth the imposition of a penalty for failure to exact a tax on behalf of the United States. And if the respondent is right that the statute is invalid as applied to its exhibitions, it ought not to have to incur the expense and burden of collection, return, and prosecution of claim for refund of a tax upon others which the State may not lawfully be required to collect. These extraordinary circumstances we think justify resort to equity.
>
> What we have said indicates that R S. 3224, *supra*, does not oust the jurisdiction. The statute is inapplicable in exceptional cases where there is no plain, adequate, and complete remedy at law. This is such a case, for here the assessment is not of a tax payable by respondent but of a penalty for failure to collect it from another. The argument that no remedy need be afforded the respondent is bottomed on the assumption that it is a mere collecting agent which cannot be hurt by collecting and paying over the tax; but this argument assumes first, that respondent did in truth collect a tax and, second, that the imposition of the tax on the purchase of admissions cannot burden a state activity. This is arguing in a circle, for these are as, upon the showing made, the respondent was unable by any other proceeding the substantial matters in controversy. We hold that the bill states a case in equity

adequately to raise the issue of the unconstitutionality of the Government's effort to enforce payment. (304 U.S. 439, 445, 448–9).

In *Midwest Haulers* v *Brady*, 128 F.2d 496 (6th Cir. 1942), a suit in equity was held appropriate on allegations that the principal assets of the taxpayer (a motor carrier) were non-transferable contracts and franchises that could not be sold at any price and whose value would be destroyed by a sale of its other assets See also *Yoshimura* v. *Alsup*, 167 F.2d 104 (9th Cir. 1948), involving a Japanese living in Hawaii who signed a Form 870 (consenting to an assessment and waiving recourse to the Tax Court) under fear of internment. Must the petitioner allege facts indicating that the tax has probably been wrongfully assessed, or is it sufficient to show that great hardship will result from collection and that a refund (if one is ultimately found to be due) would not adequately redress the taxpayer's loss?

In *Sanders* v. *Andrews*, 121 F. Supp. 584 (W.D. Okla. 1954), enforcement of a jeopardy assessment was enjoined because of "extraordinary circumstances." The taxpayer had sued the government in the Court of Claims for additional compensation on a wartime construction contract because of changes in the specifications after the work had been started. The suit was compromised, and the taxpayer claimed that the compromise agreement meant that the amount paid under it would not be taxable. The Tax Court, in *Sanders* v. *Commissioner*, 21 T.C. No. 115 (1954), found that the amount in question was ordinary income and that the compromise was not intended to affect the tax liability that might arise upon payment. Subsequently, the District Court, in an action to enjoin enforcement of the assessment and to clear title to the taxpayer's property of the tax liens, held that the compromise was intended by the parties to settle all claims between the taxpayer and the government, including his tax liability, that the jeopardy assessments were "arbitrary, capricious, vindictive, and punitive," and that their enforcement would result in the taxpayer's financial ruin.

2. It has been held that § 7421(a) does not deny the equitable remedy of injunction to a person whose property is threatened with seizure to pay someone else's tax. Thus the government can be restrained from seizing partnership property to pay the individual tax of one of the partners on the complaint of either partnership creditors or other partners. *Adler* v. *Nicholas*, 166 F.2d 674 (10th Cir. 1948); see also *Shelton* v. *Gill*, 202 F.2d 503 (4th Cir. 1953). Section 7421(b), however, forbids injunctions against assessment or collection in cases of transferee liability. Should equity intervene more freely where a transferee is involved than where the property of the taxpayer himself is about to be seized?

3. The Federal Declaratory Judgment Act was amended in 1935 to exclude federal tax controversies from its ambit. In *Filipowicz* v. *Rothensies*, 31 F Supp. 716, 722 (E.D. Pa. 1940), the court said that this amendment "should be interpreted to deny a declaratory judgment to a petitioner only where the latter could not obtain an injunction" because of § 7421(a), and added:

> In fact, such a rule would appear to be too restrictive inasmuch as there are cases where an equity court would refuse to grant an injunction because of the failure to state the need for equitable relief, while such a prerequisite would not be necessary for a declaratory judgment.

For recent cases denying declaratory judgments, see *Kyron Foundation* v. *Dunlap*, 110 F. Supp. 428 (D.C. 1952), and *Taylor* v. *Allan*, 204 F.2d 485 (10th Cir. 1953).

4. Occasionally a stockholder has successfully sued his corporation to enjoin payment of a tax. A famous example is *Pollock* v. *Farmers Loan & Trust Co.*, *supra*, p. 3; and see *Stanton* v. *Baltic Mining Co.*, *supra*, p. 64. The device may prevent a *voluntary* payment of the tax by the corporation, but it will not prevent an assessment and collection by the government. See *Reinecke* v. *Peacock*, 3 F.2d 583 (7th Cir. 1924), dismissed for want of jurisdiction, 271 U.S 643 (1926). If the stockholder's action succeeds in restraining a voluntary payment on the ground that the tax is not owing, however, will the corporation be in a better position on going to the Tax Court or on suing for a refund? If the outcome of the stockholder's suit is of no weight in a later

deficiency or refund action, is there any justification for an exercise of equity jurisdiction? How can the stockholder establish that there is a threatened loss to the corporation, in view of the availability to the corporation of the Tax Court and refund procedures?

5. Notwithstanding § 7421(a), assessment and collection can be enjoined if the Commissioner fails to send the taxpayer a 90-day letter, § 6213(a). This provision protects the taxpayer's right to go to the Tax Court without paying the tax. In keeping with this restriction, assessment and collection can be restrained until the 90-day period for filing a petition in the Tax Court has run and, if a petition is filed, until the Tax Court's decision has become final. These restrictions are in turn subject to an exception· when the Commissioner believes that assessment or collection will be jeopardized by delay, he may make a "jeopardy" assessment § 6861(a) and, subject to the restriction of § 6863(b)(3), sell any seized property.

6. See Greener, "The Injunction in Federal Tax Cases," 21 *Tenn. L. Rev.* 237 (1950), Note, Enjoining the Assessment and Collection of Federal Taxes Despite Statutory Prohibition, 49 *Harv. L. Rev.* 109 (1935).

2. *Jeopardy Assessments*

Note Section 6861(a) of the 1954 Code, relating to jeopardy assessments, is substantially the same as Section 273(a) of the 1939 Code.

Section 6863(b)(3), restricting sales of seized property in the case of a jeopardy assessment, is new.

See Regs. 118, Sec. 39.273-1.

BROWN-WHEELER CO. v. COMMISSIONER

Board of Tax Appeals, 1930
21 B.T.A. 755

LANSDON: The petitioner filed its return for 1923 on March 15, 1924, and the jeopardy assessment challenged by this appeal was made by the respondent on March 3, 1928. The original assessment was for $5,420.15; but petitioner and respondent have agreed, by stipulation, that the asserted deficiency is to be $1,941.41, and that its validity may be determined upon the sole question as to whether or not assessment and collection of such additional tax are barred by the statute of limitations.

Notice of assessment and demand for payment of the tax involved were signed by the collector of internal revenue at San Francisco, Calif. on March 14, 1928, and delivered to the petitioner on March 29, following. The written notice of assessment, required by section 279(b) of the Act of 1926, was mailed to the petitioner by respondent on March 20, 1928. The petitioner contends (1) that these acts of the Commissioner of Internal Revenue were abortive and without legal effect, inasmuch as the facts in this case, as it claims, show that the assessment or collection of this tax would not have been jeopardized by delay, and, because of such facts, the respondent was without jurisdiction to make a jeopardy assessment, and (2) that the assessment was not complete within the meaning of section 279, *supra*, until the mailing of the 60-day letter, which, in this case, was March 20, 1928, and 5 days after the expiration of the statute of limitations. The mailing of the 60-day letter, according to the contention of the petitioner, before the expiration of the statute of limitations, is a condition precedent to the validity

of any jeopardy assessment. The pertinent provisions of the Revenue Act of 1926, which control here, are as follows:

Sec. 279. (a) If the Commissioner believes that the assessment or collection of a deficiency will be jeopardized by delay, he shall immediately assess such deficiency . . . and notice and demand shall be made by the collector for the payment thereof.

(b) If the jeopardy assessment is made before any notice in respect of the tax to which the jeopardy assessment relates has been mailed under sub-division (a) of section 274, then the Commissioner shall mail a notice under such subdivision within 60 days after the making of the assessment.

It will be noted that section 279, *supra,* makes it mandatory upon the Commissioner immediately to assess the tax, if he believes that delay would jeopardize its assessment or collection. This, we hold, vests discretionary powers in the Commissioner over which we have no control. To assume jurisdiction over the Commissioner's acts, under this provision, or to question his judgment or good faith in performing them, would be to substitute our judgment and belief for that of the Commissioner, which we can not do. For these reasons, the legal basis for the acts of the Commissioner in making this assessment must be assumed. *California Associated Raisin Co.,* 1 B.T.A. 1251; *C.L. Greene,* 2 B.T.A. 148; Estate of W.S. *Tyler,* 9 B.T.A. 255.

In respect of petitioner's other contention, we think it sufficient to refer to the provisions of subdivisions (a) and (b) of section 279, *supra,* to show that, except as a condition subsequent that must be performed within 60 days, the notice provided for in the latter in no way affects the validity of the assessment made under the former. The office of this notice pertains to collection only, and if mailed to the taxpayer within the 60-day limit, prevents lapsing of the collection which, under section 278(d) and (e) of the Act, may be made within six years after assessment. *J.H. Reese,* 15 B.T.A. 1261.

Decision will be entered for the respondent.

Note

1. Here the jeopardy assessment (now regulated by § 6861) was made because the statute of limitations (at that time, four years) was about to run. This is a permissible use of a "jeopardy" even though a notice of deficiency would also protect the revenue, by virtue of §§ 6503(a) and 6512(a). See *Veeder* v. *Commissioner,* 36 F.2d 342 (7th Cir. 1929). The jeopardy assessment is much employed in fraud cases, especially if the taxpayer is engaged in an illegal enterprise, on the theory that delay in assessing or collecting the tax may prejudice the exchequer. Once an assessment has been made, the government has a lien against the taxpayer's property and a priority in the event of ensuing insolvency, rights of importance even if the assessment is not followed by steps to collect the tax. For this reason, it might be that the limited grounds for enjoining *collection* of a tax should not be sufficient to enjoin an *assessment.*

2. After a jeopardy assessment has been made, the taxpayer can stay collection of the tax by posting a bond. § 6863(a). See also § 6863(b)(3), new in the 1954 Code.

3. Another drastic device available to the Commissioner when he deems collection of the tax to be in jeopardy is to close the taxable year and demand immediate payment of the tax on the income so far earned during the current year plus the tax on the preceding year's income. In the case of a taxpayer filing on the calendar year basis, this would permit the Commissioner to demand payment on March 1 of the tax for the preceding year plus a tax on the earnings in January and February. See § 6851.

4. See generally Miller, "Jeopardy and other Summary Assessments," *7th Annual N.Y.U. Institute on Fed. Taxation* 195 (1949).

3. *Transferee Liability*

Note: **Sections 6901 and 6902, relating to transferee liability, are derived, with minor changes, from § 311 of the 1939 Code. See Regs. 118, Sec. 39.311-1.**

DENTON v. COMMISSIONER

Tax Court of the U. S., 1953
21 T.C. 295

[The two petitioners were stockholders and officers of Hartford Chrome Corporation for the fiscal years ending 1943, 1944, and 1945. In November, 1945, they, together with a third stockholder-officer, arranged to buy out the only other stockholder. His shares were purchased by the corporation, and in connection with the purchase all four parties agreed that if the corporation had any tax liability that was not disclosed on a financial statement as of September 29, 1945 (which was used for valuing the shares being purchased by the corporation) they would pay their proportionate shares of the liability to the corporation. Their proportionate shares of any such undisclosed tax liability were to be fixed in proportion to the salaries that they had received for the years for which any deficiency was assessed.

[Subsequently deficiencies were assessed against the corporation for the years 1943, 1944, and 1945, based primarily on a disallowance of officers' salaries as unreasonable in amount. These deficiencies were not reflected by the September 29, 1945 financial statement. The corporation did not contest the deficiencies, but was unable to pay them in full. The commissioner assessed deficiencies against the two petitioners as transferees.]

TIETJENS, Judge:

At the outset we dispose of the petitioners' claim that the assessment of transferee liability against them was barred by the statute of limitations. The petitioners admit that the periods of limitation for assessment were extended by consents given by the Corporation* and that the Corporation could not be heard to question the authority under which the consents were given. Nevertheless they argue that since the Corporation's board of directors did not expressly authorize the consents, they, the petitioners, not being in privity with the Corporation can here assert the lack of authority. We find no merit in this contention. We think the consents were properly executed by corporate officers. It is admitted their validity could not be questioned by the Corporation. Simply because at the time the last consent was given the petitioners had severed their connections with the Corporation should not place them in position to escape the effect of those consents. This Court has held that the statute which provides that the period of limitations for assessment of transferee liability shall be with one year after the expiration of the period of limitation for assessment against the taxpayer (See 311 (b)(1)) means "the original period of limitation against the taxpayer as properly extended by consents." *Rite-Way Products, Inc.*, 12 T.C. 475. We find nothing in the statute or the cases which would confine this construction of the statute only to transferees who happened to be in privity with the taxpayer at the time a consent was executed. The assessment of transferee liability against the petitioners is not barred by the statute of limitations.

* See § 6501(c) (4), 1954 Code. [Ed.]

We turn to the question of the petitioners' liability as transferees in equity for unpaid taxes of the Corporation. The provision of the Internal Revenue Code providing for such liability is as follows:

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) *Transferees.*—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter. . . . Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax. . . .

(f) *Definition of "Transferee."*—As used in this section, the term "transferee" includes heir, legatee, devisee, and distributee.

On the liability in equity phase of the case the Commissioner alleges that the Corporation transferred $4,650 to John as a dividend in 1943 and also transferred to him the following amounts as unreasonable salary: $10,387.88 in 1943, $6,391.69 in 1944 and $3,083.29 in 1945. With reference to James, like allegations are made, the amounts, however, being $3,000 as a dividend in 1943, and $5,105.67, $5,649.96 and $5,233.29 as unreasonable salary in the years, 1943, 1944 and 1945, respectively. It is further alleged that as a result of these transfers the Corporation was left without funds to pay its tax deficiencies and as of November 30, 1945, its assets were exceeded by its liabilities.

To hold a party liable as transferee in equity for a transferor's delinquent taxes it must be proved (1) that the alleged transferee received assets of the transferor and (2) that the transferor was insolvent at the time of, or was rendered insolvent by, the transfer of assets. *J. Warren Leach*, 21 T.C. 70 (1953). Thus, a necessary item of proof for the years 1943 and 1944 is here lacking. We have no proof of insolvency of the Corporation in those years and to the contrary, have found as a fact that it was solvent. The payment of amounts in those years to the petitioners as compensation, even though unreasonable, did not render the Corporation insolvent. Accordingly, the petitioners cannot be held liable in equity for the amounts received by them from the Corporation in 1943 and 1944.

The year 1945 presents a little different problem, for by November 30, 1945, the Corporation had become insolvent. No determination of deficiencies for that year was made by the Commissioner and his affirmative allegations that the amounts of $3,083.29 and $5,233.29 were received by John and James, respectively as unreasonable salaries constitute new matters on which the Commissioner has the burden of proof. We do not think this burden has been met and we are unable to make findings that any portion of the salaries paid to the petitioners in 1945 was unreasonable. We hold that the petitioners are not liable as transferees in equity.

This leaves us with the problem of the petitioners' liability at law. To sustain his contention that the petitioners are so liable the Commissioner makes a two-pronged argument. First, he would base such liability on the contract executed

on November 13, 1945, by the petitioners and Keane and Curtin whereby they agreed to pay a proportionate share of any "undisclosed" tax liabilities of the Corporation. Second, he argues that the petitioners became liable under Connecticut law by their conduct as directors of the Corporation in approving the purchase by the Corporation of its own shares while insolvent.[1]

We think the Commissioner must fail in these arguments for the following reasons. The liability which is sought to be imposed on the petitioners is, in the words of section 311, "the liability at law . . . of a *transferee of property* of a taxpayer . . ." [Emphasis supplied] We take this to mean that in order to hold the petitioner liable at law as transferees there must be found some liability on their part which arose either by express agreement or by operation of law in connection with or because of the transfer to them of the taxpayer's property. In *Williard M. Whitney*, 26 B.T.A. 212, it was said in regard to section 280, the predecessor of section 311, that before "the respondent may proceed under section 280 a person must be a transferee of property from the taxpayer in circumstances which make him liable at law or in equity for the tax." *Cf. United States* v. *Scott*, 167 F.2d 301. Such is not the situation here. No assets or property of the Corporation were transferred to the petitioners in connection with, in support of, or in consideration of their execution of the contract, the terms of which are set out in our findings. Neither did they receive any property of the Corporation in connection with the purchase of Curtin's shares by the Corporation. The purchase price in that transaction passed to Curtin and not to the petitioners. These transactions, the November 13, 1945 contract and the sale of stock to Curtin, were entirely unrelated to the transfers of property on which the Commissioner relies to measure the petitioners' liability, *i.e.* the alleged unreasonable salaries in 1943, 1944, 1945 and the dividend in 1943, and we do not think those transfers can be properly combined with either the contract or the Connecticut law in such a way that transferee liability at law will result. Perhaps the petitioners could be held for the Corporation's unpaid taxes in an action at law based either on the contract or the provisions of the Connecticut statute cited by the Commissioner. *Cf. Commissioner* v. *Keller*, 59 F.2d 499. Those questions we need not decide, for even were the petitioners so liable, their liabilities under the contract or the Connecticut law would not be those of a "transferee of property" within the meaning of section 311 as we construe it, and the summary collection procedure provided in that section would not be available to the Commissioner. *M. H. Graham*, 26 B.T.A. 301, appeal dismissed 63 F.2d 997. We hold that on the facts before us the petitioners are not liable at law as transferees of the Corporation's property.

[1] *The General Statutes of Connecticut (Revision of 1949) Vol. II, Sec. 5181:*

". . . No corporation shall acquire, purchase and hold its own stock unless to prevent loss upon a debt previously contracted, except with the approval of stockholders owning three-fourths of its entire outstanding capital stock given at a stockholders' meeting warned and held for that purpose; and such corporation shall not vote upon shares of its own stock. No corporation shall purchase any of its own stock when it is insolvent, or by such purchase shall render itself immediately insolvent. If any corporation shall purchase its own stock when it is insolvent, or by such purchase shall render itself immediately insolvent, the directors assenting to such purchase shall be personally liable for any debts of such corporation existing at the time of such purchase. . . ."

Note

1. Transferee liability has already been encountered in several cases. *Healy* v. *Commissioner*, *supra*, p. 741; see also the *Court Holding Co.* and *Cumberland Public Service Co.* cases, *supra*, p. 507 and 509. Such liability is occasionally based upon a contract by which the transferee of assets (*e.g.*, a successor corporation or partner) assumes the obligations of another taxpayer. More frequently, however, non-tax statutes for the benefit of creditors and equitable doctrines relating to fraudulent conveyances, "trust funds" for creditors, and the like are invoked. If the corporation involved in the *Denton* case had been insolvent in 1943 and 1944, would the unreasonable part of a salary necessarily result in transferee liability *pro tanto?* Could a trade creditor of the corporation sue to recover such a payment as a fraudulent conveyance?

As the opinion indicates, the importance of transferee liability (as against an action at law on the contract or under the Connecticut statute) is that such liability may be assessed and collected in the same manner as a tax deficiency—summarily. See *Phillips* v. *Commissioner*, 283 U.S. 589 (1931). Could the Commissioner have treated Curtin, whose shares were purchased by the corporation, as a transferee, either because of the contract or because of the purchase alone?

On transferee liability in general, see Fager, "Technical Aspects of Transferee Liability," *10th Annual N.Y.U. Inst. on Fed. Taxation* 697 (1952); Halstead, "When Is a Transferee Liable for Tax?" 1953 *So. Calif. Tax Inst.* 383, and see *Rowen* v. *Commissioner*, — F.2d — (2d Cir. 1954).

2. Section 6901(a)(1)(B) permits the same strong arm tactics against a fiduciary who distributes assets in his charge without first paying federal taxes, at least if he knows or should know of them. See *Irving Trust Co.* v. *Commissioner*, 40 B.T.A. 204 (1939). See § 6501(d), permitting a fiduciary to demand a prompt assessment of tax so as to facilitate distribution without fear of a later assessment, and note also paragraph 3(2)(a) of Mim. 6383, *supra*, p. 803.

Section C. Tax Litigation

BICKFORD
SUCCESSFUL TAX PRACTICE

New York: Prentice-Hall, Inc., 2nd Ed., 1952, pp. 292–5

It will be noted that issuance of the notice of deficiency gives to the taxpayer an election to choose which court he desires to review the determination made by the Commissioner. If he so elects, he may file a petition with the Tax Court and obtain judicial review of the determination before the tax may be assessed or collected. On the other hand, he may pay the tax,* file claim for refund, and then bring suit (after the claim has been rejected) in the District Court or the

* A taxpayer wishing to proceed via the Tax Court route without incurring an obligation to pay interest in the event he loses may pay the tax after filing a petition in the Tax Court It has been held that payment *before* the 90-day letter has issued, however, is a waiver of the Tax Court route, so that the taxpayer may then go only to the District Court or the Court of Claims. The theory is that if the tax has been paid, there is no valid notice of deficiency, essential to the Tax Court's jurisdiction. Bendheim v. Commissioner, — F.2d — (2d Cir. 1954), Walsh v. Commissioner, 21 T.C. No. 120 (1954) (A 90-day letter may be sent after payment either because of an administrative failure to credit the payment to the taxpayer's account in time or because the payment was deposited in a "suspense account" for some reason.) See Marold, "Effect of Payment of Additional Tax Upon Tax Court Jurisdiction," *12th Annual N.Y.U. Institute on Fed. Taxation* 917 (1954); Hurst, "At What Stage Will Payment of a Deficiency Deprive the Tax Court of Jurisdiction? " *7 Tax L. Rev.* 254 (1952). [Ed.]

Court of Claims in exactly the same manner as before the creation of the Tax Court. This is an absolute election afforded the taxpayer at the time a notice of deficiency is issued, and neither the courts nor the Commissioner has any authority to control his choice. On the other hand, once he makes the election, it is irrevocable. If he goes to the Tax Court, he may not thereafter go to the District Court; on the other hand, if he fails to file a petition with the Tax Court, his only judicial remedy is to pay the tax and go to the District Court or the Court of Claims.

Factors to be considered in choosing court of review. Although the burden of paying the tax and then suing for recovery is a heavy one, there are frequently sound strategic reasons why you should take your case to the District Court or the Court of Claims instead of to the Tax Court. . . . Some reasons for suing in the District Court, instead of going to the Tax Court, are as follows:

(1) Frequently the Tax Court has adopted, concerning certain points of law, a line of theory at variance with the decisions of the Courts of Appeals in certain circuits. If your case is in a circuit where such a favorable rule applies, you should most certainly bring your suit in the District Court instead of in the Tax Court where it is certain that it will be decided against you.

(2) Many times there are matters of local fact, tradition, and knowledge with which the local District Court is far more familiar than the judges of the Tax Court. If a recognition of these factors is thought to be to the advantage of your client, you should go into the District Court.

(3) In suits against the Collector in the District Courts, your client is entitled to a jury trial.† When you have a factual proposition that depends upon fair play and equitable argument rather than upon technical rules of law, you may feel that a jury would be more sympathetic. Thus, in family partnership cases, juries have shown themselves to be surprisingly on the side of the taxpayer and opposed to "bureaucratic interference" in a citizen's business affairs.

(4) Certain grounds of relief available in the District Courts are not available in the Tax Court. The Tax Court is a court of very limited jurisdiction, whereas the District Courts have broad equitable jurisdiction. Thus, if you wish to claim relief under the doctrine of equitable recoupment for offsetting taxes barred by the statute of limitations, you can raise that issue in the District Court, but the Tax Court has no jurisdiction to hear it.‡

(5) Since the Tax Court has no jurisdiction over refunds except where the Commissioner has first determined a deficiency, you may wish to bring a single action where there are several taxable years involving the same question. If the Commissioner finds an overpayment for one year and a deficiency for the following year, the two years can be combined only in the District Court.

(6) A suit in the District Court is subject to the jurisdiction of the Department of Justice for settlement purposes, whereas a case before the Tax Court is subject to the control of the Technical Staff. If a "secret ruling" in the Bureau has been cited against you as the grounds for refusal to settle, you may find the Department

† A jury trial is now permissible in suits against the United States in the District Courts, as well as in suits against the collector. 68 Stat. 589 (1954). [Ed.]

‡ *Supra*, pp 765–6. Conversely, equitable doctrines may be applied against the taxpayer in an action for a refund when they will not be in a Tax Court case. See the *Bennet* case, *supra*, p. 761. [Ed.]

of Justice inclined to ignore such an unpublished ruling, whereas the Staff is bound by it. Also, many lawyers believe that Justice Department lawyers take a much more practical view of the Government's chances of losing a case than do the technical advisors of the Technical Staff.

(7) Some lawyers think that considerable attention should be paid to the fact that the statistics contained in the last annual report of the Commissioner indicate that taxpayers recovered approximately 70 per cent of the amount sued for in District Court actions, whereas, in Tax Court cases, they eliminated less than 50 percent of the deficiency contested.

(8) There are also several important questions to be considered in deciding between the District Court and the Court of Claims. . . . [T]here is no absolute right of appeal from a decision of the Court of Claims, but only a possibility of allowance of certiorari at the discretion of the Supreme Court.

On the whole, most lawyers find in the vast majority of cases that there are no compelling reasons why a case should be brought in one court in preference to another.§ In such cases, it is most desirable to go to the Tax Court, because hearing and determination may be had there without first paying the tax. In refund cases, however, where there has been no deficiency to be made the subject of a notice, the only right of review is in the District Court or the Court of Claims.

1. Tax Court

BICKFORD
SUCCESSFUL TAX PRACTICE
New York: Prentice-Hall, Inc., 2nd Ed., pp. 298–304, 308–10*

The Tax Court "is a tribunal of limited jurisdiction, and its powers are strictly confined to those affirmatively vested in it by the act under which it is created." [1] The Court does not, therefore, have any of the broad "unwritten," or common law, powers possessed by the ordinary United States District Courts, nor does it have any broad equitable jurisdiction In fact, the Court may simply "redetermine" the amount of "deficiencies" and does not have any other authority over the policies of the Bureau of Internal Revenue, nor can it enforce its own decisions.

Generally, the Court has jurisdiction over the following matters

1. The redetermination of deficiencies involving income and excess profits taxes.

Among the matters the Court does *not* have authority to consider are the following . . .

2. Refunds of taxes where there has been no deficiency first determined by the Commissioner.
3. Moot questions.
4. Questions of administrative policy.
5. Any question involving taxes for years other than the one covered by the notice of deficiency, unless such matters directly affect the computation of the deficiency for the taxable year under review.

§ For one other advantage the district court may have over the Tax Court, see *supra*, p. 801.
* Footnotes have been freely edited, omitted, and added by the editor.
[1] Greene v. Commissioner, 2 B.T.A. 148, 149 (1925).

Essential elements of jurisdiction. § 272(a) [now § 6213(a)], which is typical of similar sections applicable to other taxes, provides in the following words for the institution of a proceeding before the Tax Court:

> If, in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this chapter, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the ninetieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the deficiency.

A careful analysis of this section indicates that essential elements of Tax Court jurisdiction are as follows:

1. The Commissioner must determine a deficiency.
2. The Commissioner must mail a notice of such deficiency.
3. Within ninety days after such notice is mailed, a petition must be filed for the redetermination of the deficiency.
4. The petitioner must be "the taxpayer."

Each of these elements is an essential requirement so far as jurisdiction of the Court is concerned; if any one of them is not satisfied, the Court lacks jurisdiction to hear the case. Such defects in jurisdiction are fundamental and may not be waived by the Court or by the parties.

Definition of "deficiency." The first requirement for the existence of jurisdiction in the Tax Court is that the Commissioner shall have determined a deficiency of income, excess profits, estate, or gift taxes. Each section of the Code relating to these four classes of taxes expressly defines "deficiency" as consisting of the following:

1. The excess of the *correct tax as determined by the Commissioner* over the following:
a. The amount shown on the return,
b. Increased by the amounts previously assessed, or collected without assessment,
c. Decreased by any rebates, credits, refund, or other repayment.[2]

Thus, the starting point in calculating a deficiency is the amount shown on the return, which is increased by any other assessments and decreased by any rebates. The net amount thus obtained must be *less than the total tax liability* determined by the Commissioner for there to be a deficiency.

The phrase "amount shown on the return" has been held by the Court to mean the amount shown on the original return, not the amount shown on an amended return or upon a tentative return. Furthermore, the amount shown on the return is to be used as the starting point in the calculation even though the amount was neither assessed nor paid. Thus, where the taxpayer filed a return showing one amount but filed with the return a statement contending that only a smaller amount was due . . . , it was held that there was no jurisdiction when the Commissioner denied this contention and found a total tax amounting to more than the taxpayer contended but less than the amount shown on the return. . . .

[T]he Individual Income Tax Act of 1942 amended § 6211(b) to provide that "the amount shown on the return" shall not include any amount paid as an esti-

[2] I.R.C. § 6211(a).

mated tax or withheld and claimed as a credit under Section 31. Thus, if $2,000 was withheld as tax on salaries paid the taxpayer as an estimated tax and the taxpayer then filed Form 1040 showing a total tax of $1,500, the amount shown on such Form 1040 ($1,500) would be used in computing the deficiency and appeal could be taken only if the Commissioner subsequently determined that the total tax should exceed $1,500.

Determination of deficiency. The second requirement for jurisdiction is that there must be a determination of a deficiency. Such determination must be one that fixes the amount of the tax—that is, a final determination by the Commissioner. Customarily such determination is made the subject of a notice of deficiency, which will be discussed in the following paragraph. Any preliminary notice, such as a revenue agent's report or the so-called 30-day letter, which notifies the taxpayer of a *proposed* deficiency and grants an opportunity to show why a deficiency should not be determined, is not a determination of a deficiency. Similarly, letters explaining the action of the Commissioner and addressed to counsel for the taxpayer are not determinations. It is also provided by statute that a mere notice of a correction of a mathematical error appearing on the face of the return is not a determination of deficiency.[3] Summing up, the determination required by the statute is a final determination by the Commissioner that the correct tax under the statute is in excess of the amount shown on the return as adjusted by additional assessments or payments and by any refunds or rebates.

Notice of deficiency. Section [6212(a) provides that] the Commissioner, after determination of a deficiency, "is authorized to send notice of such deficiency to the taxpayer by registered mail." The mailing of such a notice is essential to the establishment of jurisdiction in the Tax Court. If a petition is filed with the Court based upon a notification that does not constitute a notice of deficiency, the Court will dismiss the proceeding. . . .

It is also important to bear in mind that the Tax Court's powers extend only to the redetermination of a deficiency. The Tax Court has no power to protect the right of the petitioner to have such notice issued or to prevent the Commissioner from collecting a tax without issuing a notice. Protection of these rights must be sought in the United States District Courts by injunction, proceeding in accordance with [§ 6213(a)] . . . As a practical matter, there has been little occasion to file such injunction suits, since the Commissioner usually issues formal notices of deficiency and does not attempt to make assessments or collection until after the decision of the Tax Court becomes final. In a few cases, where the question has arisen, the right has been enforced to have the tax redetermined before collection. . . .

The final requirement for jurisdiction is that a petition must be filed by "the taxpayer." Accordingly, a petition filed by someone other than the party named in the notice and against whom no deficiency has been determined will be dismissed.

There have been, however, many decisions that seem to modify this general rule under various circumstances. Thus, an exception exists, and jurisdiction has been taken, where the deficiency notice was mailed to a deceased taxpayer and the appeal was brought by the executors of his estate. Another exception has been

[3] Sec. 6213 (b) (1).

recognized where the person filing the petition had actual authority to represent the taxpayer and no one had been misled about the liability asserted.

A number of decisions also have been rendered involving the *capacity* of the petitioner to bring suit. Where a notice has been mailed to a dissolved corporation, the question has frequently been raised whether the corporation, as such, or its directors, officers, or stockholders may file the petition. The general rule in these cases is that the capacity of a dissolved corporation to sue must be determined according to the laws of the state in which the corporation was formed. . . .

A number of somewhat similar questions have been raised in cases involving petitions filed by agents, trustees, executors, and other representatives. In all such cases the general rule is that the authority of the petitioner to act for "the taxpayer" must be judged by local law, and it has quite generally been held that if the person filing the petition had actual authority to represent "the taxpayer" against whom the deficiency was determined and no one has been misled about the liability asserted, a petition filed by an agent or representative creates valid jurisdiction.

Note

1. The requirement of § 6213(a) that the petition to the Tax Court be filed within 90 days after the notice of deficiency is mailed is jurisdictional, and the period cannot be extended by the Tax Court for reasons of equity. Before the 1954 Code was enacted, there were a number of cases involving petitions whose delivery was delayed because of interruptions in normal mail service. See Weiss, "When Is a Petition 'Filed' in the Tax Court," 8 *Tax L. Rev.* 473 (1953). Section 7502 now provides that the date on which a petition sent by mail is postmarked shall be deemed to be the date of delivery if the petition is actually delivered later; and that if the petition is sent by registered mail, registration shall be prima facie evidence that it was delivered.

See also Propp, "Incorrectly Addressed 90-Day Letters," 7 *Tax L. Rev.* 250 (1952), Hurst, "At What Stage Will Payment of a Deficiency Deprive the Tax Court of Jurisdiction?" *Id.* 254.

2. For Tax Court pleading and trial procedure, see Keir, *The Preparation and Trial of Cases in the Tax Court of the United States* (1952); Bickford, *Successful Tax Practice*, 312–63, (2d ed. 1952); Albus, "Procedure and Trial of a Case Before the Tax Court of the United States," 1 *Amer. Univ. Tax Inst.* 305 (1948), Casey, "Tax Court Procedures: Some Current Problems," 5 *Tax L. Rev.* 57 (1949).

For descriptions of Tax Court procedure by its judges, see Kern, "The Process of Decision in the United States Tax Court," *8th Annual N.Y.U. Inst. on Fed. Taxation* 1013 (1950); Murdock, "What Has the Tax Court of the United States Been Doing?" 31 *A.B.A.J.* 297 (1945).

3. Section 7441 provides that the Board of Tax Appeals is "an independent agency in the Executive Branch of the Government" and that (commencing January 1, 1943) it "shall be known as the Tax Court of the United States." Is it a court or an executive agency? The commentators have written more on this subject than the courts. Levenson, "Effect of the Administrative Procedure Act on Decisions of the Tax Court," 2 *Tax L. Rev.* 103 (1946), Brown, "The Nature of the Tax Court of the United States," 10 *U. of Pitts.* 298 (1949). The principal practical issue was whether the Tax Court was subject to the Administrative Procedure Act, enacted in 1946, which sanctioned stricter judicial review than the *Dobson* case, *supra*, p. 749, but this question became moot when the enactment of § 7482(a) modified the *Dobson* rule. See also *Kennedy Name Plate Co.* v. *Commissioner*, 170 F 2d 196 (9th Cir. 1948).

4. The Tax Court's docket has increased alarmingly in recent years. In the fiscal year 1946, 3,077 petitions were filed and 5,469 cases were pending at the end of the year, filings are currently about 9,000 per year, and at the end of the fiscal year 1952, 11,266 cases were pending. See Paul, "Directions in Which Tax Policy and Law Have Been Moving," 30 *Taxes* 949 (1952).

5. Decisions of the Tax Court are reviewed by the eleven Courts of Appeals. For proposals for a single Court of Tax Appeals, see Griswold, "The Need for a Court of Tax Appeals," 57 *Harv. L. Rev.* 1153 (1944); Miller, "Can Tax Appeals Be Centralized?" 23 *Taxes* 303 (1945); Pope, "A Court of Tax Appeals: A Call for Re-examination," 39 *A.B.A.J.* 275 (1953); Surrey, "Some Suggested Topics in the Field of Tax Administration," 25 *Wash. U. L. Q.* 399, 414–423 (1940). For another prescription, see Eisenstein, "Some Iconoclastic Reflections on Tax Administration," 58 *Harv. L. Rev.* 477 (1945).

2. *District Courts and Court of Claims*

PLUMB
TAX REFUND SUITS AGAINST COLLECTORS OF INTERNAL REVENUE

60 Harv. L. Rev. 695, 686–7, 691–702, 705–07☆
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At the present time, a taxpayer desiring to recover an overpayment of federal taxes may choose one of several modes of procedure. He may, without restriction on amount, sue the United States in the Court of Claims. He may sue the United States in the district court located in the district of his residence if the amount of his claim, including interest to the date of commencement of the action, is not in excess of $10,000, or, even though the claim exceeds $10,000, if the collector to whom the tax was paid is dead or out of office when suit is begun.* In addition to these remedies, the taxpayer in most cases, irrespective of the amount of his claim, may bring suit in the district court against the collector to whom the tax was paid. . . .

The suit against the collector for a refund is a most anomalous action. The assessment of federal internal revenue taxes is the responsibility of the Commissioner of Internal Revenue. When the Commissioner certifies an assessment to the collector, that official has a purely ministerial duty to effect its collection. He can neither "revise nor refuse to enforce the assessment regularly made." [1] The collector who collects an erroneous tax neither commits a wrong nor personally profits by it. One would expect that he, like the sheriff acting in a lawful manner under an execution regular on its face, would be protected from personal liability to an aggrieved taxpayer. But in fact, although the collector is, of course, indemnified against paying the refund out of his own pocket,[2] he is deemed "personally" liable for erroneous or illegal taxes collected by him. . . .

☆Footnotes have been freely edited, omitted, and added by the editor. [Ed.]

* These monetary restrictions were dropped in 1954. *Infra*, p. 849. [Ed.]

1 Erskin v. Hohnbach, 14 Wall. 613, 616 (U.S. 1871).

2 See Regs. 118, Sec. 39.322-4, referring to 28 U.S.C. 2006, providing that any judgment against a collector for taxes paid into the Treasury shall be paid by the Treasury if the court certifies either that probable cause existed or that he acted under orders.

Where Congress has not acted to alter the incidents of the action [against the collector] . . . the courts strictly and consistently consider its character "personal." If the collector to whom the tax was paid is no longer in office, it is not permissible to sue his successor, in his official capacity; the action must be against the former collector, a private citizen. If the former collector is dead, recovery must be had from his estate. If the collector or former collector against whom the suit is commenced dies while it is pending, the action may be revived against his estate. The "personal" character of the action is also reflected in the fact that, while a suit against the United States may be brought in the judicial district of the taxpayer's own residence, a suit against the collector, like any private suit in the federal courts, must be brought in the district of the defendant's residence, which may well be in another part of the state, inconvenient for parties and witnesses.

The most obvious of the many unfortunate effects of the fiction was that it prevented the application of the rule of res judicata in subsequent suits on the same cause of action or suits involving the identical issue, even though the real party in interest, the Government, assumed the defense of each suit and had bound itself to pay any judgment. Thus, a taxpayer who had once litigated his liability for a certain period in a suit against a collector was permitted to sue again on the same tax liability against the United States, since the United States was regarded as a stranger to the former "personal" action. And an issue which had been adjudicated in an action against a collector was not deemed conclusively established for purposes of a subsequent action concerning another tax period, if the United States, the Commissioner of Internal Revenue, or a different collector was a party to the later suit. The courts were, however, by no means consistent: the collector in his "personal" capacity was uniformly held to be bound by a judgment in a prior suit to which either the United States or the Commissioner, as its official representative, was a party.

In 1942, Mr. Randolph Paul, on behalf of the Treasury Department, asked the House Committee on Ways and Means to eliminate suits against collectors, owing primarily to the fact that the existence of such suits permitted the relitigation of issues and causes of action. The Committee was persuaded, however, that the only serious objection to the existing procedure was its effect on res judicata, and it determined to meet the problem, not by requiring that the real party in interest be made an actual party for all purposes, but by providing that the doctrine of res judicata should henceforth be applied "*as if* the United States had been a party" to any refund suit brought against a collector.[3]

If the effect on res judicata, which has thus been remedied, were the only unfortunate consequence of the "personal" liability of the collector, it might now be tolerated. But in fact it enmeshes the taxpayer in a maze of rules that may deprive him of his remedy irrespective of the merits of his case, and from which no equitable relief may be obtained, unless the defendant voluntarily abstains from raising the technical defense. These rules are rigidly applied by the courts with no regard for the maxim that "fictions of law shall not be permitted to work any wrong."

It is commonly assumed that a suit in the district court against the proper collector or former collector is always available as a means of obtaining a tax refund.

[3] § 7422 (c), 1954 Code.

Yet in certain instances of fairly frequent occurrence a suit against the United States, which must be brought in the Court of Claims unless the amount involved is under $10,000, is the sole remedy. Where, as often happens, an additional tax is assessed against a taxpayer at a time when he is entitled to a refund of an overpayment for another period, possibly arising out of the same transaction, the overpayment may be applied as a credit on the additional tax liability. If the taxpayer disputes his liability for the additional tax, it appears that he has the option to sue for the tax which had been found to be overpaid, treating the credit as a denial of his claim for the refund. In that case the Government may raise the additional tax as an offset. Or he may treat the credit as a payment of the additional tax and sue directly for its refund. To choose the latter form of procedure would seem preferable, since it is only with respect to the additional tax that a litigable issue exists. But a taxpayer who makes such a choice, unless well advised of the Supreme Court decisions, faces a technical pitfall. For, in *Lowe Brothers Co.* v. *United States*,[4] the Court held that the collector in office at the time when the collection of the additional tax was effected by credit had received no money from the taxpayer but had merely given force, by ministerial action, to the Commissioner's application of money already in the Treasury. . . Thus was fiction carried to the extreme, for "an overpayment in cash cannot be realistically distinguished from an overpayment by credit." [5]

The same technical doctrine was applied in the *Hammond-Knowlton* case[6] to another fairly common situation. There, suit was first brought against the collector for an estate tax refund based on the credit for state inheritance taxes which had been paid after the federal estate tax had been collected without allowance of the credit. The defendant pleaded the statute of limitations, but lost in the district court. On appeal, the defendant raised for the first time (after the statute of limitations would have barred a new action against the United States) the argument that suit against the collector could not be maintained, because the tax was not excessive when collected but only became so when the state taxes were subsequently paid. The Court of Appeals for the Second Circuit accepted that argument, holding that the subsequent payment of state taxes did not make the federal tax illegal ab initio and that the error, if any, was not that of the collector, but that of the Commissioner, in disallowing the credit. The executrix, unable at that time to bring a *new* action against the United States, waived a substantial part of her claim in order to reduce it to the jurisdictional limit of $10,000 † and amended her complaint to substitute the United States as defendant. The district court permitted the amendment, and again the Circuit Court of Appeals reversed, holding that a suit against the collector could not be converted into a suit against the United States after the time for commencing the latter had expired. Judge Frank's encyclopaedic dictum reviewing the whole doctrine and calling upon the

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[4] 304 U S 302 (1938).

[5] United States v. Piedmont Mfg. Co., 89 F 2d 296, 298 (4th Cir 1937), decided prior to the Lowe case, *supra* note 4, and overruled by it. [This procedural quirk of a suit against a collector was later corrected. Section 7422(d), enacted in 1949, provides that where a tax is satisfied by crediting against it an overpayment of another tax, the satisfaction shall be deemed a "payment" to the collector in office at the time the credit is allowed. Ed.]

[6] Hammond-Knowlton v. Hartford-Connecticut Trust Co., 89 F.2d 175 (2d Cir 1937).

† See *infra*, p. 849. [Ed.]

Supreme Court to reverse his decision fell upon deaf ears, and the Supreme Court declined to review the case.

While the courts have not yet extended the holdings of the *Lowe Brothers* and *Hammond-Knowlton* cases to other situations, their logic might be applied elsewhere. For example, it might be argued that the collector is not the proper party to be sued for a refund where the tax was correct when paid but became erroneous as a result of a retroactive amendment of the law. The same contention might be raised where a tax, correct when paid, is claimed to have become excessive as a result of a carry-back of a net operating loss or of an unused excess profits credit. And it has been argued that a suit for refund against the collector will not lie where the tax has been paid pursuant to a final closing agreement and that the Commissioner and the Secretary of the Treasury are necessary parties to an attack upon the validity of their contract.

Taxpayers who have sued a collector when they had no option other than to sue the United States have not been alone in their misfortunes. Every year a certain number of them suffer dismissal of their suits because they name the wrong collector as defendant. In some cases the mistake may result from the reasonable assumption that the incumbent collector represents the United States and is the appropriate defendant, in others, particularly where suit is filed under pressure when the statute of limitations is about to expire, it may result from lack of information as to the dates when a collector entered or left office or the exact time of payment.

When a taxpayer sues the wrong collector, or sues a collector when he should have sued the United States, he may, of course, commence a new action against the proper party. But by the time he has discovered his error, or been advised of it by a court, the period of limitations may well have expired. Yet it is not permissible to amend the complaint to substitute the United States or the proper collector as a party, since to do so is deemed the equivalent of commencing a new action. Nor is the taxpayer, who foresees a possibility that the collector may not be sued, but who wants the benefits of a collector suit, able to protect himself by joining the collector and the United States as alternative defendants in the district court . . . or by commencing a protective action in the Court of Claims.

One is reminded of common law practice, of which it has been said:

> . . . At [the plaintiff's] peril he must select the appropriate formula. It was not enough that he stood within the temple of justice, he must have entered through a particular door.

The tale, however, is not yet complete. More difficulties arise where a taxpayer has paid portions of the same tax to two or more different collectors. In that situation, the taxpayer is free to split his action for recovery of the tax and may bring separate suits against each of the collectors to whom portions of the tax were paid, or against the present collector and subsequently against the United States for a payment made to the former collector. The Revenue Act of 1942 makes the decision in the first case determined res judicata in the others, so far as the issues are identical.[7] But it does not prevent further litigation of the same tax liability on other issues, provided the collector is named the defendant in the first suit, since payments to different collectors are deemed distinct causes of action.

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[7] *Supra*, note 3.

If, on the other hand, the taxpayer desires to dispose of the matter in a single action, . . . it appears that he is permitted to join the collectors as defendants in a single action; but it is doubtful whether the United States, in lieu of a former collector, may be joined with the present collector as a party. If joinder of the United States is permitted, a problem may arise from the fact that the same issue may be triable as of right by a jury with respect to the portion of the tax for which the collector is sued, and triable by the court as to the balance.‡

If the Government, in defense of a refund suit, wishes to assert not merely that there was no overpayment but that the tax for the year in suit was underpaid, it may counterclaim for the additional tax, provided the United States is the formal defendant. But if the collector is named as the defendant, it seems that he may not raise a counterclaim asking an affirmative judgment for the additional tax, since suits (and hence counterclaims) for the collection of taxes must be brought in the name of the United States rather than by the collector. In that situation, it has been deemed necessary for the United States to intervene in order to assert the additional tax. But if the matters to be raised by the Government merely go to reduce the taxpayer's recovery and will not result in additional tax, the collector may raise the offset without the necessity of intervention by the United States. Yet, although the issue in such a case is whether there has been an overpayment, and although the Commissioner ordinarily has broad powers to audit the books of a taxpayer to determine that issue, it has been held that the Commissioner has no interest in the "personal" suit against the collector and may not use his powers of investigation to supplement those available to the latter as a "private" litigant.

In certain situations, a taxpayer may seek to offset or recoup against a tax liability a barred overpayment in another tax, arising out of the same transaction as the additional tax. How far the equitable doctrine of recoupment may be availed of in tax cases is in serious doubt. But, assuming that recoupment is allowed in some situations, its application should be unaffected by any changes that may have occurred in the personnel of the Bureau of Internal Revenue. Yet, in *Electric Storage Battery Co.* v. *Rothensies*,[8] where the Government had collected a tax on income resulting from a refund of excise taxes (which had been deducted in prior years) and the taxpayer sought to recoup a barred overpayment of like excises covering an earlier period, the Government argued that suit would not lie against the collector who collected the *income* tax. It was contended that the error was not that of the defendant but that of his predecessors who collected the excises, and that he could not be held "personally" liable for their acts. The Court of Appeals for the Third Circuit overcame the Government's contention by technical reasoning, declaring that "If this is technical, it is no more so then the argument which it answers." The Supreme Court found it unnecessary to pass on the question since it held recoupment not allowable for other reasons, but the contention remains a hurdle which may have to be leaped in more meritorious cases.

The "personal" character of the action against the collector is further reflected in certain of its incidents. A suit against the United States, for example, is tried without a jury,§ while jury trial is allowed as a matter of right in collector suits.

[8] 152 F.2d 521, 526 (3d Cir. 1945), *rev'd*, 329 U.S 296 (1946).

‡ Trial by jury is now allowed in suits against the United States. 68 Stat. 589 (1954). [Ed.]

§ See *infra*, p. 847n.

Whether this rarely exercised right should be preserved, or eliminated as inappropriate for the determination of most types of tax issues has been the subject of hot debate in which the writer has no desire to mix. But the availability of a jury trial to a taxpayer should not depend on whether he can obtain service on a former collector who has gone to Florida to retire, or whether the tax was collected by credit against an overpayment, rather than in cash. And the Government's equal right to demand a jury trial in an appropriate case, should not be at the mercy of the taxpayer's choice of defendant....

None would defend the unreasonable and often unjust operation of the rules surrounding the action against the collector. The institution of collector suits, nevertheless, has found staunch defenders, owing primarily to certain incidents that are lacking in suits against the United States—the principal one, of course, being the right of trial by jury. It is, however, within the power of Congress to attach to suits against the United States every desirable incident which inheres in the existing action against the collector. While the Tucker Act provides, in general, for trial of suits against the United States without a jury, it is not unprecedented for Congress to allow jury trials in special classes of such suits. To permit jury trials in tax refund suits against the United States would give taxpayers no right which they may not now enjoy simply by bringing their actions against collectors, except in those unusual cases where technical rules (having nothing to do with the appropriateness of the case for a jury) prevent such suits. In fact, eliminating the dual remedy and providing for jury trials in suits against the United States would have the desirable effect of giving the Government the option in any case to demand a jury trial, which the taxpayer alone really has at present.

The opponents of the proposal, however, seem to have seen a deeper menace. The fear has been expressed that the elimination of suits against collectors would be the opening wedge for the adoption of a more drastic proposal, much discussed some years ago, entirely to deprive the district courts and the Court of Claims of tax refund jurisdiction and to make the Tax Court of the United States the exclusive tribunal for such cases. It was felt that the suit against the collector, not being against the sovereign, affords a greater protection to taxpayers than a suit against the United States, which can be withdrawn or modified by Congress, subject to no constitutional restriction. It is the opinion of the writer, however, that withdrawing the right to sue the collector for tax refunds, if accompanied by the granting of the unrestricted right to sue the United States, would not place the taxpayer in any different position than at present. Congress has the constitutional power to withdraw the right to sue the collector for tax refunds or to deny trial by jury in such cases, just as it has with respect to suits against the United States. If it is true, as was suggested in one case, that Congress has no constitutional power to withdraw *both* the right to sue the United States and the right to sue the collector, the taxpayer is not harmed by the present proposal, for in the event that the proposal is adopted and Congress then asserts the immunity of the United States from suit, the right to sue the collector will again spring into existence by constitutional implication, notwithstanding any law to the contrary. On the other hand, if Congress has power to withdraw all right to obtain a refund in the district courts, either against the collector or against the United States, conditioned only on the provision of an adequate remedy through the Tax Court

or other administrative body, that power is in no way enhanced by the fact that the right to sue the collector may first have been withdrawn.

Note

1. The Bureau reorganization in 1952, replacing the Collectors by "Directors" of Internal Revenue, did not abolish the personal action for refund. See Brodsky, "Suits for Refund: The Nature of the Suit and the Procedure to be Followed," *11th Annual N.Y.U. Inst. on Fed. Taxation* 749, 759–766 (1953).

2. Before 1954, this tangled subject was complicated further by the fact that the United States could be sued in the District Court only if the claim did not exceed $10,000, unless the collector to whom the tax was paid was dead or out of office when the suit was begun. This was why the executrix in the *Hammond-Knowlton* case, *supra*, p. 845, waived part of her claim when she amended the complaint to substitute the United States as defendant (While the jurisdiction of the Court of Claims was unlimited in amount, it was clearly too late for her to sue the United States there.) In 1954, the Judicial Code was amended to give the district courts unlimited jurisdiction in tax suits against the United States, and, at the same time, trial by jury was allowed in such cases. 68 Stat 589 (1954). As the Plumb article points out, trial by jury was always permissible in suits against collectors, and there were no monetary limitations on the jurisdiction of the district courts in such suits.

3. A curious possibility of concurrent jurisdiction over the same taxable year in both the district court or Court of Claims and the Tax Court has been taken care of by § 7422(e), new in the 1954 Code. Previously, if the taxpayer filed suit for refund in the district court or Court of Claims and the Commissioner issued a notice of deficiency for the same year while the suit was pending, the taxpayer could appeal the deficiency notice to the Tax Court, and presumably a race to judgment could then take place between the two courts. See Senate Report, pp 610–611

3. Res Judicata

COMMISSIONER v. SUNNEN

Supreme Court of the U. S., 1948
333 U.S 591

Mr. Justice MURPHY delivered the opinion of the Court.

The problem of the federal income tax consequences of intra-family assignments of income is brought into focus again by this case.

The stipulated facts concern the taxable years 1937 to 1941, inclusive, and may be summarized as follows.

The respondent taxpayer was an inventor-patentee and the president of the Sunnen Products Company, a corporation engaged in the manufacture and sale of patented grinding machines and other tools. He held 89% or 1,780 out of a total of 2,000 shares of the outstanding stock of the corporation. His wife held 200 shares, the vice-president held 18 shares and two others connected with the corporation held one share each. The corporation's board of directors consisted of five members, including the taxpayer and his wife. This board was elected annually by the stockholders. A vote of three directors was required to take binding action.

The taxpayer had entered into several non-exclusive agreements whereby the corporation was licensed to manufacture and sell various devices on which he had applied for patents. In return, the corporation agreed to pay to the taxpayer a royalty equal to 10% of the gross sales price of the devices. These agreements

did not require the corporation to manufacture and sell any particular number of devices, nor did they specify a minimum amount of royalties. Each party had the right to cancel the licenses, without liability, by giving the other party written notice of either six months or a year. In the absence of cancellation, the agreements were to continue in force for ten years. The board of directors authorized the corporation to execute each of these contracts. No notices of cancellation were given. Two of the agreements were in effect throughout the taxable years 1937–1941, while the other two were in existence at all pertinent times after June 20, 1939.

The taxpayer at various times assigned to his wife all his right, title and interest in the various license contracts. She was given exclusive title and power over the royalties accruing under these contracts. All the assignments were without consideration and were made as gifts to the wife, those occurring after 1932 being reported by the taxpayer for gift tax purposes. The corporation was notified of each assignment.

In 1937 the corporation, pursuant to this arrangement, paid the wife royalties in the amount of $4,881.35 on the license contract made in 1928; no other royalties on that contract were paid during the taxable years in question. The wife received royalties from other contracts totaling $15,518.68 in 1937, $17,318.80 in 1938, $25,243.77 in 1939, $50,492.50 in 1940, and $149,002.78 in 1941. She included all those payments in her income tax returns for those years, and the taxes she paid thereon have not been refunded.

Relying upon its own prior decision in *Estate of Dodson* v. *Commissioner*, 1 T.C. 416, the Tax Court held that, with one exception, all the royalties paid to the wife from 1937 to 1941 were part of the taxable income of the taxpayer. 6 T.C. 431. The one exception concerned the royalties of $4,881.35 paid in 1937 under the 1928 agreement. In an earlier proceeding in 1935, the Board of Tax Appeals dealt with the taxpayer's income tax liability for the years 1929–1931; it concluded that he was not taxable on the royalties paid to his wife during those years under the 1928 license agreement. This prior determination by the Board caused the Tax Court to apply the principle of *res judicata* to bar a different result as to the royalties paid pursuant to the same agreement during 1937.

The Tax Court's decision was affirmed in part and reversed in part by the Eighth Circuit Court of Appeals. 161 F.2d 171. Approval was given to the Tax Court's application of the *res judicata* doctrine to exclude from the taxpayer's income the $4,881.35 in royalties paid in 1937 under the 1928 agreement. But to the extent that the taxpayer had been held taxable on royalties paid to his wife during the taxable years of 1937–1941, the decision was reversed on the theory that such payments were not income to him. Because of that conclusion, the Circuit Court of Appeals found it unnecessary to decide the taxpayer's additional claim that the *res judicata* doctrine applied as well to the other royalties (those accruing apart from the 1928 agreement) paid in the taxable years. We then brought the case here on certiorari, the Commissioner alleging that the result below conflicts with prior decisions of this Court.

If the doctrine of *res judicata* is properly applicable so that all the royalty payments made during 1937–1941 are governed by the prior decision of the Board of Tax Appeals, the case may be disposed of without reaching the merits of the

controversy. We accordingly cast our attention initially on that possibility, one that has been explored by the Tax Court and that has been fully argued by the parties before us.

It is first necessary to understand something of the recognized meaning and scope of *res judicata*, a doctrine judicial in origin. The general rule of *res judicata* applies to repetitious suits involving the same cause of action. It rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound "not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose." *Cromwell* v. *County of Sac*, 94 U.S. 351, 352, 24 L. Ed. 195. The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties upon any ground whatever, absent fraud or some other factor invalidating the judgment. See von Moschzisker, "Res Judicata," 38 *Yale L.J.* 299; *Restatement of the Law of Judgments*, §§ 47, 48.

But where the second action between the same parties is upon a different cause or demand, the principle of *res judicata* is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but "only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered." *Cromwell* v. *County of Sac*, *supra*, 353 of 94 U.S. . . . Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, *res judicata* is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. See *Restatement of the Law of Judgments*, §§ 68, 69, 70; Scott, "Collateral Estoppel by Judgment," 56 *Harv. L. Rev.* 1.

These same concepts are applicable in the federal income tax field. Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a partciular tax year is litigated, a judgment on the merits is *res judicata* as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. Collateral estoppel operates, in other words, to relieve the government and the taxpayer of "redundant litigation of the identical question of the statute's application to the taxpayer's status." *Tait* v. *Western Md. R. Co.*, 289 U.S. 620, 624, 53 S. Ct. 706, 707, 77 L. Ed. 1405.

But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur with-

out substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers of the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability, and a fertile basis for litigious confusion. Compare *United States* v. *Stone & Downer Co.*, 274 U.S. 225, 235, 236, 47 S. Ct. 616, 71 L. Ed. 1013. Such consequences, however, are neither necessitated nor justified by the principle of collateral estoppel. That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers.

And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. *Tait* v. *Western Md. R. Co., supra.* If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation. See *Travelers Ins. Co.* v. *Commissioner*, 2 Cir., 161 F.2d 93. And where the situation is vitally altered between the time of the first judgment and the second, the prior determination is not conclusive. See *State Farm Ins. Co.* v. *Duel*, 324 U.S. 154, 162, 65 S. Ct. 573, 577, 89 L. Ed. 812; 2 Freeman on *Judgments*, 5th Ed. 1925, § 713. As demonstrated by *Blair* v. *Commissioner*, 300 U.S. 5, 9, 57 S. Ct. 330, 331, 81 L. Ed. 465, a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable. But the intervening decision need not necessarily be that of a state court, as it was in the *Blair* case. While such a state court decision may be considered as having changed the facts for federal tax litigation purposes, a modification or growth in legal principles as enunciated in intervening decisions of this Court may also effect a significant change in the situation. Tax inequality can result as readily from neglecting legal modulations by this Court as from disregarding factual changes wrought by state courts. In either event, the supervening decision cannot justly be ignored by blind reliance upon the rule of collateral estoppel. . . . It naturally follows that an interposed alteration in the pertinent statutory provisions or Treasury regulations can make the use of that rule unwarranted. *Tait* v. *Western Md. R. Co., supra*, 625 of 289 U.S., 53 S. Ct. 706.

Of course, where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. See *Evergreens* v. *Nunan*, 2 Cir., 141 F.2d 927. And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change. But if the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does

not govern the legal issues which recur in the second case. Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. It may then reach a different result or, if consistency in decision is considered just and desirable, reliance may be placed upon the ordinary rule of *stare decisis*. Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment. *Tait* v. *Western Maryland R. Co.*, *supra*. And see Griswold, "*Res Judicata* in Federal Tax Cases," 46 *Yale L.J.* 1320; Paul and Zimet, "*Res Judicata* in Federal Taxation," appearing in Paul, *Selected Studies in Federal Taxation*, 2d series, 1938, p. 104.

It is readily apparent in this case that the royalty payments growing out of the license contracts which were not involved in the earlier action before the Board of Tax Appeals and which concerned different tax years are free from the effects of the collateral estoppel doctrine. That is true even though those contracts are identical in all important respects with the 1928 contract, the only one that was before the Board, and even though the issue as to those contracts is the same as that raised by the 1928 contract. For income tax purposes, what is decided as to one contract is not conclusive as to any other contract which is not then in issue, however similar or identical it may be. In this respect, the instant case thus differs vitally from *Tait* v. *Western Md. R. Co.*, *supra*, where the two proceedings involved the same instruments and the same surrounding facts.

A more difficult problem is posed as to the $4,881.35 in royalties paid to the taxpayer's wife in 1937 under the 1928 contract. Here there is complete identity of facts, issues and parties as between the earlier Board proceeding and the instant one. The Commissioner claims, however, that legal principles developed in various intervening decisions of this Court have made plain the error of the Board's conclusion in the earlier proceeding, thus creating a situation like that involved in *Blair* v. *Commissioner*, *supra*. This change in the legal picture is said to have been brought about by such cases as *Helvering* v. *Clifford*, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788; *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L. Ed. 75, 131 A.L.R. 655; *Helvering* v. *Eubank*, 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81; *Harrison* v. *Schaffner*, 312 U.S. 579, 61 S. Ct. 759, 85 L. Ed. 1055; *Commissioner* v. *Tower*, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670; and *Lusthaus* v. *Commissioner*, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679. These cases all imposed income tax liability on transferors who had assigned or transferred various forms of income to others within their family groups, although none specifically related to the assignment of patent license contracts between members of the same family. It must therefore be determined whether this *Clifford-Horst* line of cases represents an intervening legal development which is pertinent to the problem raised by the assignment of the 1928 agreement and which makes manifest the error of the result reached in 1935 by the Board. If that is the situation, the doctrine of collateral estoppel becomes inapplicable. . . .

[After reviewing the *Clifford-Horst* line of cases, the Court concluded:]

The principles which have thus been recognized and developed by the *Clifford* and *Horst* cases, and those following them, are directly applicable to the transfer

of patent license contracts between members of the same family. They are guideposts for those who seek to determine in a particular instance whether such an assignor retains sufficient control over the assigned contracts or over the receipt of income by the assignee to make it fair to impose income tax liability on him.

Moreover, the clarification and growth of these principles through the *Clifford-Horst* line of cases constitute, in our opinion, a sufficient change in the legal climate to render inapplicable in the instant proceeding, the doctrine of collateral estoppel relative to the assignment of the 1928 contract. True, these cases did not originate the concept that an assignor is taxable if he retains control over the assigned property or power to defeat the receipt of income by the assignee. But they gave much added emphasis and substance to that concept, making it more suited to meet the "attenuated subtleties" created by taxpayers. So substantial was the amplification of this concept as to justify a reconsideration of earlier Tax Court decisions reached without the benefit of the expanded notions, decisions which are now sought to be perpetuated regardless of their present correctness. Thus in the earlier litigation in 1935, the Board of Tax Appeals was unable to bring to bear on the assignment of the 1928 contract the full breadth of the ideas enunciated in the *Clifford-Horst* series of cases. And, as we shall see, a proper application of the principles as there developed might well have produced a different result, such as was reached by the Tax Court in this case in regard to the assignments of the other contracts. Under those circumstances collateral estoppel should not have been used by the Tax Court in the instant proceeding to perpetuate the 1935 viewpoint of the assignment....

The judgment below must therefore be reversed and the case remanded for such further proceedings as may be necessary in light of this opinion.

Reversed.

Mr. Justice FRANKFURTER and Mr. Justice JACKSON believe the judgment of the Tax Court is based on substantial evidence and is consistent with the law, and would affirm that judgment for reasons stated in *Dobson* v. *Commissioner*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248, and *Commissioner* v. *Scottish American Co.*, 323 U.S. 119, 65 S. Ct. 169, 89 L. Ed. 113.

Note

1. In addition to the Griswold and Paul and Zimet articles cited by the Court, see Sellin, "The *Sunnen* Case—A Logical Terminus to the 'Issue' of Res Judicata in Tax Cases," 4 *Tax L. Rev.* 363 (1949). In *United States* v. *International Bldg. Co.*, 345 U S 502 (1953), it was held that a judgment of the Tax Court (on a question of basis for computing depreciation), entered by consent of the parties without adjudication on the merits, does not give rise to an estoppel by judgment for another year.

2. *Lynch* v. *Commissioner*, 20 T.C. 1052 (1953), involved the validity of a family partnership for the years 1944 and 1945. In 1941 the Tax Court had held that the same partnership was valid in a proceeding based on a deficiency determined for the year 1937. The Court held in the second proceeding that the *Tower* and *Culbertson* cases, *supra*, p. 339, had rendered "obsolete the legal concept" upon which its earlier decision had been based, so that neither *res judicata* nor collateral estoppel was applicable. Four dissenting judges took the position that the earlier proceeding had found *as a fact* that the petitioner had made a valid gift of capital interests in the business to his children and that the parties in good faith intended to carry on the business as partners. They argued, therefore, that the *Sunnen* case was inapplicable.

Section D. Interest and Penalties

1. Interest

Note: **Section 6601 of the 1954 Code, relating to interest on deficiencies, is based, with some modifications, on § 292 of the 1954 Code.**

PRIESS v. UNITED STATES

U. S. District Court, E.D. Wash., 1941
42 F. Supp. 89

SCHWELLENBACH, District Judge.

In this action plaintiff asks judgment for the amount of interest paid by him under protest on the deficiency assessments levied against him on his income taxes for the years 1936–1939 inclusive. The facts are not in dispute. In plaintiff's returns during each of these years he reported as income on his single premium life insurance annuities, with death benefit contract, 3% of the consideration paid for the annuity part of the insurance policies. These returns were made in conformity with the interpretation placed upon the Statute by the Internal Revenue Bureau (General Counsel Memorandum 6395). Thereafter, on January 8, 1940, defendant, through its Internal Revenue Bureau, adopted a new interpretation of Section 22(b) (2) of the Revenue Act of 1936 (General Counsel Memorandum 21716). Under this interpretation it was held that such single premium life insurance annuities, with death benefit contracts, were not annuity contracts but contracts for the payment of the interest or earnings on a certain fund. Under the new interpretation, plaintiff's income for tax purposes during each of the years mentioned was substantially increased. Thereafter, a deficiency assessment was imposed, § 271 [now § 6211]. Included in such a deficiency as a part of the tax was interest at the rate of 6% per annum from the date prescribed for the payment of the tax to the date the deficiency was assessed. Int. Rev. Code, § 292. Plaintiff paid the principal of the deficiency without objection but he paid the interest portion of the deficiency under protest and this action is to compel the refunding of such interest.

It is conceded that, in making his returns and in paying his taxes during the period mentioned, plaintiff complied fully with the requirements of the defendant and the defendant's interpretation of the Statute. Plaintiff's theory in this case is that, as to him, the collection of interest constituted a penalty. He makes this contention on the basis that he neither borrows nor lends money. He has retired from business. All of his funds are invested. He spends his income for personal living expenses, traveling expenses and donations to charity. He, therefore, argues that the retention of the money which he should have paid during each of the involved years was of no value to him and that, therefore, he should not be penalized by being compelled to pay for the use of it since he was without fault.

To this contention, defendant answers that this Court has no authority to render judgment on recovery of either taxes or interest collected in pursuance of an Act of Congress enacted in pursuance of its constitutional authority. *Jackson Furniture Company* v. *McLaughlin*, 9 Cir., 85 F.2d 606; *United States* v. *Globe Indemnity Company*, 2 Cir., 94 F.2d 576.

To my mind, this is a complete answer. The Statute is plain and unambiguous. It reads:

> Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax, at the rate of 6 per centum per annum from the date prescribed for the payment of the tax. . . . (Int. Rev. Code § 292.)

Clearly, in the light of the Statute and the ruling of the Circuit Court of Appeals of the Ninth Circuit, *Jackson Furniture Company* v. *McLaughlin*, *supra*, it does not lie within my power to undo the action of the Commissioner in which he was following the plain, simple mandate of the Statute.

However, plaintiff makes a forceful and an appealing argument on the basis that he is being penalized when he was in fact innocent of wrongdoing. So forcible and so appealing is plaintiff's argument that I feel constrained to examine closely the question as to whether this is a penalty.

It is evident that the Congress, in providing interest on deficiency assessments, did not consider such interest to be a penalty. This is shown by the fact that, in two separate sections of the Act apart from the interest on deficiency section, the Congress provided for penalties. In § 291 [now § 6651(a)], there is provided the penalty for failure to file a return. In § 293 [now § 6653(a)], there are provided penalties for deficiencies due to negligence or intentional disregard of rules and regulations and for deficiencies due to fraud with intent to evade the tax. The legislative intent to distinguish between penalty and interest is clear.

Plaintiff, in his brief, states that he has been unable to find any cases dealing directly with this question. There are a number of cases which, on careful analysis, will be seen to deal with precisely the same question raised by the plaintiff here. These are cases involving the bankruptcy statute, 11 U.S.C.A. § 93, subd j, which prohibits the allowance of debts to the United States or any state or subdivision thereof as a penalty or forfeiture. These cases involved the question of interest provisions in taxing statutes where the rate of interest was in excess of the legal rate allowed by the statutes of the state where the taxpayer lived. It was the contention in those cases that, since the legislature of the state had determined that money in that particular state was worth only a certain percent of interest for its use, that any taxing statute which required the payment of more than the statutory interest rate was not interest but was a penalty and, therefore, not allowable as a credit in the bankruptcy court. We should remember, at this point, that plaintiff contends that the use of the money was of no value to him and, therefore any charge for its use should be classed not as interest but as a penalty. Keeping this argument in mind, the pertinency of the bankruptcy cases is apparent. A number of the District Courts have upheld plaintiff's contention and have reduced the allowances to the amount of the statutory interest rate. In re *Ashland Emery & Corundum Co.*, D.C., 229 F. 829, In re *Denver & R. G. W. R. Co.*, D.C., 27 F. Supp. 983; In re *168 Adams Building Corporation*, D.C., 27 F. Supp. 247.

However, in the case of *Unemployment Reserves Commission of California* v. *Meilink*, 116 F.2d 330, the Circuit Court of Appeals for the Ninth Circuit just a year ago passed upon this question fully and squarely. It based its decision on the decision of the Supreme Court of the United States in the case of *United States* v. *Childs*, 266 U.S. 304, 45 S. Ct. 110, 111, 69 L. Ed. 299. It quotes at length from the opinion in the *Childs* case. Included in such quotations are the following:

Besides, the federal statute is precise, and it is made peremptory by the distinction between "penalty" and "interest," and if it may be conceded that the use of the latter word would not save it from condemnation if it were in effect the former, it cannot be conceded that 1 per cent. per month—12 per cent. a year—gives it that illegal effect, certainly not against legislative declaration that is within the legislative power, there being no ambiguity to resolve. . . . The tax in this case is one on income, a burden imposed for the support of the government. Interest is put upon it and so denominated, distinguished from the 5 per cent. as penalty, clearly intended to compensate the delay in payment of the tax—the detriment of its nonpayment, to be continued during the time of its nonpayment—compensation, not punishment.

In his very carefully considered opinion in the *Unemployment Reserves Commission* case, Judge Wilbur reviews the decisions on the question in the various circuit courts of appeals and points out that only one circuit is at variance with the rule enunciated in *United States* v. *Childs*, *supra*. There can be no doubt but that the decision in this case must be controlled by the decision of the Supreme Court in *United States* v. *Childs*, *supra*, and of the Circuit Court of Appeals in *Unemployment Reserves Commission of California* v. *Meilink*, *supra*.

In the conclusion of his brief, plaintiff appeals strongly upon the basis of justice and fairness and, in effect, asks me to disregard the provision of the Statute. The answer to that argument is that if assessment of interest charge against this plaintiff is unfair, it is because he occupies a position which is occupied by such a small percentage of our population that Congress could not be expected to legislate specially for them. The number of persons in plaintiff's position for whom the use of money is of no value is negligible. Furthermore, the point which plaintiff overlooks is that interest is charged not only because of the value to the one who uses it but also as compensation to the one who has been deprived of the use of it.

The action must be dismissed.

Note

See generally Webster, "Interest on Deficiencies and Inchoate Deficiencies," 8 *Tax L. Rev.* 481 (1953).

See *supra*, p. 816, on the effect of signing Forms 870 and 870-AS on the running of interest.

2. *Addition for Late Filing or Failing to File*

> *Note:* **Section 6651(a) of the 1954 Code, imposing a penalty for failure to file a return on the due date, is similar to § 291(a) of the 1939 Code.**

HAYWOOD LUMBER & MINING CO. v. COMMISSIONER

U. S. Court of Appeals, Second Circuit, 1950
178 F.2d 769

SWAN, Circuit Judge.

The taxpayer is a personal holding company. The Commissioner determined deficiencies in personal holding company surtaxes for the years 1941 and 1942 and added thereto a 25 percent penalty, pursuant to § 291 [§ 6651(a) of the 1954 Code], for petitioner's failure to file personal holding company returns for

those years.* The sole question presented to the Tax Court and likewise here is whether the taxpayer's failure to file personal holding company returns for the years in suit was "due to reasonable cause and not due to willful neglect." [1] The Tax Court held that it was not due to reasonable cause.

"Reasonable cause" has been defined by the Regulations to mean that the taxpayer exercised ordinary business care and prudence. Treas. Reg. 103, § 19.291–1; see *Southeastern Finance Co.* v. *Commissioner*, 5 Cir., 153 F.2d 205; *Girard Inv. Co.* v. *Commissioner*, 3 Cir., 122 F.2d 843, 848, certiorari denied 314 U.S. 699, 62 S. Ct. 479, 86 L. Ed. 559, citing Klein, *Federal Income Taxation* 1674. In the case at bar Mr. Sprague, the taxpayer's secretary-treasurer, requested a certified public accountant, Mr. Wolcott, who was competent to advise on tax matters, to prepare the proper corporate tax returns for the years 1941 and 1942. Sprague fully disclosed to Wolcott all necessary information about the corporation and Wolcott knew that the taxpayer was a personal holding company but "through inadvertence" did not inform Sprague of this fact nor submit to him a personal holding company surtax return. Sprague was aware of the personal holding company surtax statute but he had never studied its application and it did not occur to him that the petitioner was a personal holding company. He filed on behalf of the corporation only the returns prepared by Wolcott. Because Sprague did not "specifically inquire" of Wolcott "concerning the personal holding company status of petitioner" but "merely awaited passively for such tax advice as Wolcott might volunteer to give," the Tax Court held, one judge dissenting, that petitioner had not sustained the burden of proving that ordinary business care and prudence were exercised in failing to file the personal holding company surtax returns.

With this conclusion we disagree. When a corporate taxpayer selects a competent tax expert, supplies him with all necessary information, and requests him to prepare proper tax returns, we think the taxpayer has done all that ordinary business care and prudence can reasonably demand. Sprague had not "awaited passively for such tax advice" as Wolcott "might volunteer to give"; he affirmatively requested the preparation by his consultant of proper returns.[2] To require Mr. Sprague to inquire specifically about the personal holding company act nullifies the very purpose of consulting an expert. We doubt if anyone would suggest that a client who stated the facts of his case to his lawyer must, in order to show ordinary business care and prudence, inquire specifically about the applicability of various legal principles which may be relevant to the facts stated The courts have recognized that reliance on the advice of counsel [3] or of expert accountants,[4] sought and received in good faith is "reasonable cause" for failing to file a tax return. We think those cases are correctly decided and in principle control the case at bar. The Tax Court relies on *Hermax Co.* v. *Commissioner*, 3 Cir., 175 F 2d 776, affirming 11 T.C. 442. There the accountant was not qualified

* A separate personal holding company return is no longer required. § 6501(f), 1954 Code. [Ed.]

[1] I.R.C., Sec. 291

[2] Mr. Sprague testified as to his conversation with Mr. Wolcott: "I advised him, 'Here are the Hayward figures'—I had brought my books with me—'if there have been any changes in the law we don't know about, you tell us and prepare the return'."

[3] C. R. Lindback Foundation v. Commissioner, 4 T C 652, 667, affirmed, 3 Cir, 150 F.2d 986, Dayton Bronze Bearing Co. v. Gilligan, 6 Cir., 281 F 709.

[4] Hatfried, Inc., v Commissioner, 3 Cir., 162 F.2d 628, Orient Inv. & Finance Co. v. Commissioner, 83 U.S. App. D.C. 74, 166 F.2d 601

to advise about tax matters and the corporation's president testified to no reason why he relied on him. Here the undisputed evidence showed that Wolcott had had over twenty years of extensive tax experience with a prominent accounting firm in Binghamton and had advised the petitioner on tax matters in previous years.

The respondent contends that where all responsibility for the preparation of tax returns is delegated to an agent, the taxpayer should be held to accept its agent's efforts *cum onere* and be chargeable with his negligence. That was the rationale suggested by this court in *Berlin* v. *Commissioner*, 59 F.2d 996, certiorari denied 287 U.S. 642, 53 S. Ct. 90, 77 L. Ed. 555. Further reflection convinces us that that proposition is not sound. The standard of care imposed by section 291 is personal to the taxpayer. To impute to the taxpayer the mistakes of his consultant would be to penalize him for consulting an expert; for if he must take the benefit of his counsel's or accountant's advice *cum onere*, then he must be held to a standard of care which is not his own and one which, in most cases, would be far higher than that exacted of a layman. The cases which hold that advice sought and received in good faith from a competent adviser constitutes reasonable cause for failure to file the required return are inconsistent with the *cum onere* doctrine suggested in the *Berlin* case.

In *Paymer* v. *Commissioner*, 2 Cir., 150 F.2d 334, 337 we said that reasonable cause was a question of fact and "therefore presents no reviewable issue." This abbreviated statement does not state the whole principle, which is better expounded in *Hatfried, Inc.* v. *Commissioner*, 3 Cir., 162 F.2d 628, 635. As there pointed out, whether the elements which constitute "reasonable cause" are present is a question of fact, but what elements must be present to constitute "reasonable cause" is a question of law. The Tax Court erred in our opinion upon this question of law. Accordingly the decision must be modified to strike out the penalties in personal holding company surtax for the years 1941 and 1942 in the respective amounts of $567.77 and $923.83.

Note

1. What if the taxpayer goes to an expert and answers all questions accurately, but does not volunteer essential data because he does not understand its significance? See *Tarbox Corp.* v. *Commissioner*, 6 T.C. 35 (1946); *Genesee Valley Gas Co.* v. *Commissioner*, 180 F.2d 41 (D.C. Cir. 1950). In *Commissioner* v. *American Association of Engineers Employment, Inc.*, 204 F.2d 19 (7th Cir. 1953), the taxpayer proved that it failed to file returns because an attorney with wide experience in federal taxation had advised in writing that it was an exempt organization. The opinion was not in evidence, nor did the taxpayer establish what information had been furnished to the attorney as a basis for his opinion. The Tax Court held that reasonable cause for the failure to file was shown, and the Court of Appeals affirmed, saying:

> The Tax Court could also assume that a reputable and experienced attorney who had a wide practice in the tax field, would not render an opinion, either written or verbal, on the question of the liability of a client for federal taxes without being in possession of the facts necessary to determine that question. (204 F.2d at 21.)

Note that an attorney might render an opinion on the basis of information furnished to him by a client without making an independent investigation, and the facts assumed by him might not be correct. What of advice from officials of the Bureau of Internal Revenue? See the *Stockstrom* case, *supra*, p. 824, and compare *Lawrence Block Co.* v. *Commissioner*, 12 T.C. 366 (1949) with *Hugh Smith, Inc.* v. *Commissioner*, 8 T.C. 660

(1947). See generally Lewis, "What Is Competent Tax Advice?" 28 *Taxes* 33 (1950); Dendy, "How Effectively Can A Taxpayer Hide Behind His Adviser: What Is a Qualified Adviser?" *10th Annual N.Y.U. Inst. on Fed. Taxation* 723 (1952).

2 What is a "return?" See *O'Sullivan Rubber Co.* v. *Commissioner*, *supra*, p. 597; and see also *Commissioner* v. *Lane-Wells Co.*, 321 U.S. 219 (1944). In *Germantown Trust Co. v Commissioner*, 309 U.S. 304 (1940), the taxpayer filed the tax return prescribed for trusts, though it should have filed a corporate return because it was an "association" under § 7701(a)(3). The form that was filed, however, supplied "all information necessary to the calculation of any tax which might be due." The court held that this was a "return" so as to set the statute of limitations running. See *Harrington Co.* v. *Commissioner*, 6 T.C. 720 (1946), holding that a signed and notarized "tentative return" (containing only the taxpayer's name, address, an estimate of total tax due, and a statement that an amended return would be filed with detailed figures) was not a "return" for § 6651(a).

3. Note that § 6651(a) requires the taxpayer not only to negate "willful neglect" but also to show that his delinquency was due to "reasonable cause." In *Rogers Hornsby* v. *Commissioner*, 26 B.T.A. 591 (1932), the 25 per cent addition was imposed where the taxpayer prepared and executed the return before the due date, leaving it with his wife when he left for spring training to file on March 15th, and she through forgetfulness filed it two months late. "The penalty may be avoided only if the tardy filing was due to a reasonable cause and not to willful neglect. Both conditions must exist. Here the only excuse is that one of the petitioners forgot to file them. This can scarcely be said to be a 'reasonable cause' for failing to perform such an important act."

4. See generally Gordon, "Income Tax Penalties," 5 *Tax L. Rev.* 131, 167–180 (1950).

3. *Addition for Negligence*

Note· **Section 6653(a) of the 1954 Code, imposing a penalty for negligence or intentional disregard of rules and regulations, is similar to § 293(a) of the 1939 Code.**

RUSHING v. COMMISSIONER

Tax Court of the U. S, 1952
¶ 52,117 P-H Memo TC, aff'd. — F.2d — (5th Cir. 1954)

JOHNSON, Judge.

This proceeding involves deficiencies in income tax and penalties for the calendar years 1946, 1947 and 1948....

FINDINGS OF FACT

Petitioner was in the oil field contracting business. His work consisted of servicing wells, constructing derricks, setting units, swabbing wells, pulling rods and tubing, and general construction work in the oil field. He employed from 10 to 40 people in this work.

Petitioner in each of the taxable years kept no formal books and records. His income tax returns were prepared by an accountant from information furnished by the taxpayer. The source of this information was cancelled checks and bank statements. Petitioner did not maintain separate bank accounts for his business or personal needs.

Prior to the preparation of his income tax returns, he grouped his checks in certain categories of expenses, such as travel, entertainment and repairs and ob-

tained total amounts therefrom. During the conferences with the internal revenue agent, petitioner regrouped these checks into other categories and obtained new total. Later, at the hearing, he regrouped these checks for the third time and thus established the third set of expense figures. In each group of checks presented at the hearing allegedly representing expenses for travel, advertising and entertainment, there were checks made payable to cash, individuals, restaurants, liquor stores, drug stores, grocery stores, and clothing stores. Only in general terms and from his memory was petitioner able to give the number and names of persons entertained and the amounts of alleged expenses for gifts and advertising....

OPINION

Petitioner, a taxpayer without legal knowledge or experience, was not represented by counsel in this proceeding. Before the hearing began, the court suggested to the petitioner that due to the large sum of money involved, the rules governing the admission of evidence, and the Court's inability to try the case for him, it might be advisable for him to be represented by counsel. The Court offered to delay the hearing, if the petitioner so desired, so that counsel might be obtained. The petitioner declined the offer and proceeded to try the case himself.

From the record it is evident that petitioner did not prepare his case; nor did he present evidence by which we might determine the validity of his claims concerning his expenses. Aside from petitioner's testimony, which fails to substantiate his contentions, he only presented four exhibits. Each exhibit consisted of an envelope containing cancelled checks. Exhibit No. 1, entitled "1946 Travel $3,079.45," contains some 62 cancelled checks. Exhibit No. 2, entitled "Travel, Entertainment & Advertising -8-[1948] $3,768.83," contains 99 cancelled checks. Exhibit No. 3, entitled "Entertainment & Adv. $1,917.50," contains 62 cancelled checks. Exhibit No. 4, entitled "1946 Materials & Supplys [sic] $18,239.94," contains some 131 cancelled checks. As stated in the facts, each group of checks was made payable to various persons and business establishments. Petitioner admitted that some portion could have been used for personal expenses. He was unable, except in a general way, to account for any of these expenses.

We have carefully examined the checks and from them alone we can not allocate the expenses to the various expense accounts as suggested by the petitioner. Moreover, we can not adopt petitioner's contentions as to the total amounts expended for travel, advertising, entertainment, depreciation, repairs, materials and supplies, and office expenses. The adjustments as determined by the respondent must be sustained.

It is well established that all deductions from gross income are a matter of legislative grace rather than a matter of right. *White* v. *United States*, 305 U.S. 281. A denial of the claimed deductions by the respondent carries a presumption of correctness. *Welch* v. *Helvering*, 290 U.S. 111. The burden of proving the inconsistencies of respondent's determination is placed upon the petitioner. Rule 32, Rules of Practice of the Tax Court. Petitioner has failed, with one exception, as explained below, to meet this burden. Our decision is not in conflict with the *Cohan* rule, *Cohan* v. *Commissioner*, 39 F.2d 540, for here reasonable deductions have been allowed by the respondent.

The petitioner contends that the respondent has erred in determining the depreciation expense. From the revenue agent's report we find that the estimated

life of petitioner's machinery was increased by one or more years and therefore the depreciation rate per year on some equipment was reduced. The petitioner failed to show that the respondent's determination was in error. The respondent, however, does show that some items which the petitioner deducted as expenses were properly capital improvements and so accounted for by the respondent in the depreciation schedule. The respondent's depreciation schedule is approved.

Petitioner also alleges error in respondent's determination of penalties under § 293(a) [see § *6653*, 1954 Code]. In regard to the negligence penalty under section 293(a), a finding that the return is incorrect, or that the taxpayer did not keep proper or complete records or that his calculations are confusing, is not enough to warrant the imposition of the penalty. *Bennett* v. *Commissioner*, 139 F.2d 961 affirming Memorandum Opinion of the Tax Court. We can not find on this record that petitioner intentionally disregarded the rules and regulations of the Commissioner. While petitioner's bookkeeping methods would seem to be open to a certain amount of criticism, this falls short of an intentional disregard of the regulations. The respondent's determination on this point is disapproved.

Note

1. It would be a rash taxpayer who modelled his behavior on that of the petitioner in this case. In other cases, unsubstantiated or baseless estimates have been regarded as "negligence" and a failure to keep adequate records as "intentional disregard of rules and regulations" under § 293(a). See the last paragraph of the *Bechelli* case, *supra*, p. 770. The cases are collected, though they can hardly be reconciled, in Gordon, "Income Tax Penalties," 5 *Tax L. Rev.* 131, 161–167 (1950). Are the regulations prescribing the records to be kept, Regs. 118, Sec. 39.54–1, so vague that they cannot be "intentionally disregarded" except by a failure to keep any records at all? Are cancelled checks, bank statements, and a list of cash receipts and disbursements sufficient for a cash basis taxpayer? Are receipts, for payments in cash and/or by check, necessary? Are invoices essential? Must a person whose only income is a salary and who uses the optional standard deduction keep any records? Smith, "What Are Adequate Records for the Preparation of Income Tax Returns," *11th Annual N.Y.U. Inst. on Fed. Taxation* 1235 (1953).

See *Fischer* v. *United States*, 212 F.2d 441 (10th Cir. 1954), involving a taxpayer who had written and published a booklet entitled "Mind Your Own Business," including among other things a recommended method for keeping records to avoid income tax difficulties. The booklet was held admissible in evidence, in a trial of the taxpayer for tax evasion, to prove willfulness on his part in understating income. Apparently he had relied on a lack of records to establish that his omissions were innocent.

2. The 5 per cent penalty for negligence may be imposed in addition to the 25 per cent penalty for failure to file or for a late filing. For an example, see *Chimchirian* v *Commissioner*, 42 B.T.A. 1437, 1442 (1940), aff'd. p.c. 125 F.2d 746 (D.C. Cir. 1942).

3. The rather complex pre-1954 rules on penalties for failure to file declarations of estimated tax and for substantial underestimates were eliminated by the 1954 Code, which substituted a 6 percent addition to any "underpayment" (as defined). Sections *6654* and *6655*.

JOURNAL CO. v. COMMISSIONER

Board of Tax Appeals, 1942
46 B.T.A. 841

[Under the Revenue Act of 1938, a corporation could credit against a so-called "tentative tax" 2½% of its "dividends paid credit," which included *inter alia*

amounts paid to retire certain indebtedness. The regulations promulgated under this Act, however, provided that amounts paid to retire indebtedness that had been deducted or credited in computing the undistributed profits tax imposed by the Revenue Act of 1936 could not be credited a second time as part of the "dividends paid credit" of the 1938 Act. The taxpayer paid out certain amounts to retire indebtedness and was advised by counsel that although a credit therefor was denied by the regulations, the regulations were contrary to the statute and invalid. Accordingly, the taxpayer took the credit. The Commisioner asserted a deficiency, and added the 5% penalty of Section 293(a)* on the ground that there had been an "intentional disregard of rules and regulations."

[After holding that the regulation was valid and that the deficiency was properly asserted, the Board of Tax Appeals went on to consider the 5% penalty:]

ARNOLD: . . . The second issue, affirmatively raised in the answer, is whether any part of the deficiency is due to petitioner's negligence, or intentional disregard of respondent's rules and regulations as provided in section 293(a). Respondent rests his argument, not on any alleged negligence of the petitioner, but upon an alleged intentional disregard of rules and regulations. . . .

The issue turns upon the construction of the statutory phrase "intentional disregard of rules and regulations." The stipulated facts show that petitioner was fully cognizant of the statutory provisions [*re* "dividends paid credit"] and of respondent's interpretation thereof. Petitioner sought the advice of counsel as to what it should do under the circumstances then existing. Counsel advised that petitioner was entitled to the credit provided by [the statute] and that respondent's regulation was an invalid interpretation of the statute. Petitioner then had to decide which of two opposite constructions it would follow in making and filing its return. The stipulated facts indicate that petitioner gave careful consideration to the problem before electing to follow the advice of counsel. Its choice was made deliberately, with full knowledge that the administrative interpretation was contrariwise. Obviously, therefore, petitioner intentionally disregarded respondent's regulation.

The defense advanced is in the nature of confession and avoidance. Petitioner stipulates that it acted with knowledge but upon advice of counsel and directs attention to the division of opinion on this Board in *Spokane Dry Goods Co., supra,* as proof of the soundness of its action and as justification for its belief that the respondent's regulation was invalid. Be that as it may, the statute speaks in mandatory language when it states that if

> any part of any deficiency is due to . . . intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency. . . .

As hereinbefore demonstrated, petitioner *did* intentionally disregard the regulations, and, since this conclusion is inescapable under the stipulated facts, it is mandatory that the 5 percent addition be assessed, collected, and paid in the same manner as if it were a deficiency under section 293(a).

We have examined the authorities cited without finding one dispositive of this

* See § 6653(a), 1954 Code. [Ed.]

issue. In *Frank T. Heffelfinger*, 32 B.T.A. 1232; affirmed on another point, 87 F.(2d) 991, we found as a fact that there was no intentional disregard of rules and regulations. Clearly the stipulated facts are susceptible of no such ultimate finding in this proceeding. Most of the cases cited dealt with the 5 percent addition for negligence. In the few cases where "intentional disregard of rules and regulations" was considered, the opinions coupled negligence with intentional disregard, see *Lucian T. Wilcox*, 44 B.T.A. 373; *Gibbs & Hudson, Inc.*, 35 B.T.A. 205; and *Oscar G. Joseph*, 32 B.T.A. 1192. Negligence has neither been urged nor established in this proceeding, so none of the latter cases involved comparable situations.

Harsh though the conclusion may seem, the stipulated facts herein leave no recourse but to grant respondent's request for a 5 percent addition to the deficiency.

Decision will be entered under Rule 50.

Note

1. This decision was reversed, 134 F.2d 165 (7th Cir. 1943), because the Supreme Court in the meantime had invalidated the challenged regulation. *Helvering* v. *Sabine Transportation Co.*, 318 U.S 306 (1943). Is this the kind of "intentional disregard of rules and regulations" that should be penalized? Note that the effect of imposing the penalty in this kind of case is to place a premium on District Court litigation. May the penalty be imposed if a deficiency is caused by an intentional challenge of the validity of a *statute*, if no rules and regulations have been promulgated? Does the term "rules" embrace every publicly announced Bureau ruling and interpretation?

The Senate version of the 1954 Code proposed to overrule this decision "if the taxpayer has reasonable grounds for believing the rule or regulations to be invalid and if he attaches to his return a statement sufficient to apprise" the government of his "grounds for believing them invalid." The provision was eliminated by the conference committee, no reasons being given.

2. See *Kellems* v. *United States*, 97 F. Supp. 681 (D. Conn. 1951), involving a publicly announced refusal to comply with the income tax withholding provisions in order to test their constitutionality. The court imposed a penalty because the taxpayer did not consult an attorney before violating the act and, so far as the record showed, did not even try to ascertain whether the constitutionality of the provisions had already been judicially sustained. The court's decision was in a refund action against the United States; in other counts, where the Collector of Internal Revenue was the defendant, a jury trial was had and it did not impose the penalty. The statute in question (§ 2707(a) of the 1939 Code, made applicable to the withholding of taxes by §§ 1627 and 1430 of the 1939 Code) was somewhat different from § 6653(a), in that the penalty was imposed on any person "who willfully fails to . . . collect . . . and pay over the tax."

3. See Hoffman, "International Disregard of Rules and Regulations," 28 *Taxes* 111 (1950).

4. Civil Fraud

Note: **Section 6653(b) of the 1954 Code, imposing a penalty for fraud, is based on § 293(b) of the 1939 Code.**

HELVERING v. MITCHELL

Supreme Court of the U. S., 1938

303 U. S. 391

MR. JUSTICE BRANDEIS delivered the opinion of the court.

Revenue Act of 1928, § 293 provides, in dealing with assessment of deficiencies

in income tax returns: "(b) *Fraud.* If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid."

The question for decision is whether assessment of the addition is barred by the acquittal of the defendant on an indictment under I.R.C. § 145 (b)* for a willful attempt to evade and defeat the tax.

The Commissioner of Internal Revenue found that Charles E. Mitchell of New York had, in his income tax return for the year 1929, fraudulently deducted from admitted gross income an alleged loss of $2,872,305.50 from a purported sale of 18,300 shares of National City Bank stock to his wife; that he had fraudently failed to return the sum of $666,666.67 received by him as a distribution from the management fund of the National City Company, of which he was chairman; and that these fradulent acts were done with intent to evade the tax. On December 8, 1933, the Commisioner notified Mitchell that there was a deficiency in his tax return of $728,709.84 and, on account of the fraud, a 50 per cent addition thereto in the sum of $364,354.92.

Mitchell appealed to the Board of Tax Appeals, which sustained the Commissioner's determination. *Mitchell* v. *Com'r,* 32 B.T.A. 1093. Upon a petition for review, the Circuit Court of Appeals concluded that there was ample evidence to support the Board's findings that Mitchell had fraudulently made deduction of the loss and that he had fraudulently failed to return the amount received from the management fund; and that, despite the facts hereafter stated, the Board was free to find the facts according to the evidence. It accordingly affirmed the assessment of the deficiency of $728,709.84; but it reversed the Board's approval of the additional assessment of $364,354.92, because of the following facts:

Before the deficiency assessment was made Mitchell had been indicted in the federal court for Southern New York under § 145 (b), which provides:

> Any person . . . who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the cost of prosecution.

The first count charged that Mitchell "unlawfully, wilfully, knowingly, feloniously, and fraudently did attempt to defeat and evade an income tax of, to wit, $728,709.84, upon his net income for 1929." He was tried on the indictment and acquitted on all counts. The item of $728,709.84 set out in the first count is the same item as that involved in the deficiency assessed; and both arose from the same transactions of Mitchell. But the addition of $364,354.92 by reason of fraud was not involved in the indictment.

The Circuit Court of Appeals held that the prior judgment of acquittal was not a bar under the doctrine of res judicata; and hence it affirmed the assessment of the $728,709.84. But it held that our decision in *Coffey* v. *United States,* 116 U.S. 436, 6 S. Ct. 437, 29 L. Ed. 684, and *United States* v. *La Franca,* 282 U.S. 568, 51 S. Ct. 278, 75 L. Ed. 551, required it "to treat the imposition of the penalty of 50 percent. as *barred by the prior acquittal of* Mitchell in the criminal action." *Mitch-*

* See § 7201, 1954 Code. [Ed.]

ell v. *Com'r*, 2 Cir., 89 F.2d 873, 878. Mitchell's petition for certiorari to review so much of the judgment as upheld the assessment of the deficiency of $728,709.84 was denied. The Commissioner's petition to review so much of the judgment as denied the 50 per centum in addition was granted, because of the importance in the administration of the revenue laws of the questions presented and alleged conflict in decisions.

First. Mitchell contends that the claim for the 50 per cent. is barred by the doctrine of res judicata. He asserts that all the facts and intents requisite to the imposition of the 50 per centum addition to the deficiency were put in issue and determined against the Government in the criminal trial, and that hence, under the doctrine of res judicata, the judgment of acquittal bars it from obtaining a second judgment based upon the same facts and intents. Since this proceeding to determine whether the amount claimed is payable as a tax is a proceeding different in its nature from the indictment for the crime of willfully attempting to evade the tax, the contention that the doctrine of estoppel by judgment applies rests wholly on the assertion that the issues here presented were litigated and determined in the criminal proceeding. Compare *Tait* v. *Western Maryland Ry. Co.*, 289 U.S. 620, 623, 53 S. Ct. 706, 707, 77 L. Ed. 1405. But this is not true.

The difference in degree of the burden of proof in criminal and civil cases precludes application of the doctrine of res judicata. The acquittal was "merely . . an adjudication that the proof was not sufficient to overcome all reasonable doubt of the guilt of the accused." *Lewis* v. *Frick*, 233 U.S. 291, 302, 34 S. Ct. 488, 492, 58 L. Ed. 967. It did not determine that Mitchell had not willfully attempted to evade the tax. That acquittal on a criminal charge is not a bar to a civil action by the Government, remedial in its nature, arising out of the same facts on which the criminal proceeding was based has long been settled. *Stone* v. *United States*, 167 U.S. 178, 188, 17 S. Ct. 778, 42 L. Ed. 127; *Murphy* v. *United States*, 272 U.S. 630, 631, 632, 47 S. Ct. 218, 71 L. Ed. 446. Compare *Chantangco* v. *Abaroa*, 218 U.S. 476, 481, 482, 31 S. Ct. 34, 54 L. Ed. 1116. Where the objective of the subsequent action likewise is punishment, the acquittal is a bar, because to entertain the second proceeding for punishment would subject the defendant to double jeopardy; and double jeopardy is precluded by the Fifth Amendment whether the verdict was an acquittal or a conviction. *Murphy* v. *United States*, 272 U.S. 630, 632, 47 S. Ct. 218, 71 L. Ed. 446.

The Government urges that application of the doctrine of res judicata is precluded also by the difference in the issues presented in the two cases; that although the indictment and this proceeding arise out of the same transactions and facts, the issues in them are not the same; that on the indictment the issue was whether Mitchell had "willfully" attempted to "evade or defeat" the tax; that whether he had done so "fraudulently" was not there an issue, *United States* v. *Scharton*, 285 U.S. 518, 52 S. Ct. 416, 76 L. Ed. 917; compare *United States* v. *Murdock*, 290 U.S. 389, 397, 54 S. Ct. 223, 226, 78 L. Ed. 381; and that in this proceeding the issue is specifically whether the deficiency was "due to fraud." Compare *Burton* v. *United States*, 202 U.S. 344, 380, 26 S. Ct. 688, 50 L. Ed. 1057, 6 Ann.Cas. 362. Since there was not even an adjudication that Mitchell did not willfully attempt to evade or defeat the tax, it is not necessary to decide whether such an adjudication would be decisive also of this issue of fraud. Compare *Hanby* v. *Commissioner*, 4 Cir., 67 F.2d 125, 129.

Second. Mitchell contends that this proceeding is barred under the doctrine of double jeopardy because the 50 per centum addition of $364,354.92 is not a tax, but a criminal penalty intended as punishment for allegedly fraudulent acts. Unless this sanction was intended as punishment, so that the proceeding is essentially criminal, the double jeopardy clause provided for the defendant in criminal prosecutions is not applicable.

1. In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts. This disclosure it requires him to make in his annual return. To ensure full and honest disclosure, to discourage fraudulent attempts to evade the tax, Congress imposes sanctions. Such sanctions may confessedly be either criminal or civil. As stated in *Oceanic Steam Navigation Co.* v. *Stranahan*, 214 U S. 320, 339, 29 S. Ct. 671, 676, 53 L. Ed. 1013

> In accord with this settled judicial construction the legislation of Congress from the beginning, not only as to tariff, but as to internal revenue, taxation, and other subjects, has proceeded on the conception that it was within the competency of Congress, when legislating as to matters exclusively within its control, to impose appropriate obligations, and sanction their enforcement by reasonable money penalties, giving to executive officers the power to enforce such penalties without the necessity of invoking the judicial power.

Congress may impose both a criminal and a civil sanction in respect to the same act or omission; for the double jeopardy clause prohibits merely punishing twice, or attempting a second time to punish criminally, for the same offense. The question for decision is thus whether section 293(b) imposes a criminal sanction. That question is one of statutory construction. Compare *Murphy* v. *United States*, 272 U.S. 630, 632, 47 S. Ct. 218, 71 L. Ed. 446.

Remedial sanctions may be of varying types. One which is characteristically free of the punitive criminal element is revocation of a privilege voluntarily granted. Forfeiture of goods or their value and the payment of fixed or variable sums of money are other sanctions which have been recognized as enforceable by civil proceedings since the original revenue law of 1789. Act of July 31, 1789, c. 5, § 36, 1 Stat. 29, 47. In spite of their comparative severity, such sanctions have been upheld against the contention that they are essentially criminal and subject to the procedural rules governing criminal prosecutions. . . .

2. The remedial character of sanctions imposing additions to a tax has been made clear by this Court in passing upon similar legislation. They are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud. In *Stockwell* v. *United States*, 13 Wall. 531, 547, 551, 20 L. Ed 491, the Court said of a provision which added double the value of the goods:

> It must therefore be considered as remedial, as providing indemnity for loss And it is not the less so because the liability of the wrongdoer is measured by double the value of the goods received, concealed, or purchased, instead of their single value. The act of abstracting goods illegally imported, receiving, concealing, or buying them, interposes difficulties in the way of a government seizure, and impairs, therefore, the value of the government right. It is, then, hardly accurate to say that the only loss the government can sustain from concealing the goods liable to seizure is their single value, or to assert that the liability imposed by the statute of double the value is arbitrary and without reference to indemnification. Double the value may not be more than complete indemnity. . . .
>
> The act of 1823 was, as we have seen, remedial in its nature. Its purpose was to secure full compensation for interference with the rights of the United States.

3. In I.R.C. sections 276 and 293,† it is provided that collection of the 50 per centum addition, like that of the primary tax itself, may be made "by distraint" as well as "by a proceeding in court." If the section provided a criminal sanction, the provision for collection by distraint would make it unconstitutional. Compare *Lipke* v. *Lederer,* 259 U.S. 557, 42 S. Ct. 549, 66 L. Ed. 1061; *Regal Drug Corporation* v. *Wardell,* 260 U.S. 386, 43 S. Ct. 152, 67 L. Ed. 318. . . . That Congress provided a distinctly civil procedure for the collection of the additional 50 per centum indicates clearly that it intended a civil, not a criminal, sanction. Civil procedure is incompatible with the accepted rules and constitutional guaranties governing the trial of criminal prosecutions, and where civil procedure is prescribed for the enforcement of remedial sanctions, those rules and guaranties do not apply. Thus the determination of the facts upon which liability is based may be by an administrative agency instead of a jury, or if the prescribed proceeding is in the form of a civil suit, a verdict may be directed against the defendant; there is no burden upon the Government to prove its case beyond a reasonable doubt, and it may appeal from an adverse decision; furthermore, the defendant has no constitutional right to be confronted with the witnesses against him, or to refuse to testify; and finally, in the civil enforcement of a remedial sanction there can be no double jeopardy. . . .

Third. Mitchell insists that *Coffey* v. *United States,* 116 U.S. 436, 6 S. Ct. 437, 29 L. Ed. 684, requires affirmance of the judgment; the Government argues that this case is distinguishable, and, if not, that it should be disapproved. The Circuit Court of Appeals, citing *Stone* v. *United States,* 167 U.S. 178, 186-189, 17 S. Ct. 778, 42 L. Ed. 127, and later cases, recognized that the rule of the *Coffey* case "did not apply to a situation where there had been an acquittal upon a criminal charge followed by a civil action requiring a different degree of proof"; but construing section 293(b) as imposing a penalty designed to punish fraudulent tax dodgers "and not as a mere preventative measure," it thought that the *Coffey* case and *United States* v. *La Franca,* 282 U. S. 568, 51 S. Ct. 278, 75 L. Ed. 551, required it "to treat the imposition of the penalty of 50 per cent. as barred by the prior acquittal of Mitchell in the criminal action." Since we construe section 293(b) as imposing a civil administrative sanction, neither case presents an obstacle to the recovery of the $364,354.92, the 50 per centum addition here in issue.

Reversed.

MR. JUSTICE MCREYNOLDS is of opinion that the judgment of the Circuit Court of Appeals should be affirmed.

MR. JUSTICE CARDOZO and MR. JUSTICE REED took no part in the consideration or decision of this case.

MITCHELL v. COMMISSIONER

118 F.2d 308

U. S. Court of Appeals, Fifth Circuit, 1941

Before SIBLEY, HOLMES, and MCCORD, Circuit Judges.

SIBLEY, Circuit Judge.

The Board of Tax Appeals adjudged that William E. Mitchell should pay addi-

† §§ 6502(a) and 6659, 1954 Code. [Ed.]

tional income taxes for the year 1930, though barred, and a penalty of fifty percent additional, because of fraud in the tax return with intent to evade the tax. Mitchell petitions for review upon the grounds that the particular facts found by the Board do not in law authorize the conclusion of fraud with intent to evade tax, and that there was no evidence of fraud, but only of mistake and negligence.

The pleadings before the Board involved the taxes of five years, but the Board found in favor of Mitchell as to all save the year 1930. The allegations were at first general, but on Mitchell's motion for particulars the Commissioner amended by quoting the untrue items in the returns and stating the amount in dollars of the falsity, and concluded "(w) That the petitioner at the time of filing said federal income tax returns . . . knew the same to be false and nevertheless filed them with the intent that they should be accepted as true and correct." Mitchell replied by expressly admitting the incorrectness alleged, but as to (w) "Denies that the petitioner at the time of filing said federal income tax returns knew the same to be false; but admits the petitioner filed said returns with intent that they should be accepted as true and correct." The single issue therefore specifically drawn was whether Mitchell when he filed the 1930 return knew or did not know it was untrue.

The burden of proof was upon the Commissioner. Internal Revenue Code, Sec. 1112,* *Griffiths* v. *Commissioner*, 7 Cir., 50 F.2d 782. To sustain it he swore as witnesses Mitchell, and P. H. Nabors who had prepared the return. Mitchell denied positively and with indignation that he knew the return was in any respect untrue; he had no books of account, but turned his papers and files over to Nabors whom he regarded as reliable and competent, and accepted the returns he prepared for all the years in question without checking the computations or doubting their correctness. Nabors also testified positively that he alone prepared the return, and what mistakes were made were his own, that he had no request from Mitchell to distort facts and would not have done that if asked to; that the mistakes made were wholly unintended and unknown, and that Mitchell did not check his computations so far as he knew. The returns, all of which for the years in question were made out by Nabors, were really complicated and he made many mistakes in them both for and against Mitchell. Stocks of the corporations for which Mitchell was working had been bought by him at different prices in forty-six purchases over ten years, there had been several stock dividends and reorganizations which complicated the costs, and there were about eighty-eight different sales. Mitchell was an engineer and not an accountant. Nabors had a high school education and business and clerical experience but also was not an accountant. Very large mistakes were made later in an audit by a capable revenue agent; and an accountant employed by Mitchell whose work the Commissioner approved and adopted also went astray, as the Board itself found, and it corrected his results in Mitchell's favor. The particular error or falsity on which alone the Board condemned the 1930 return was that Nabors attributed a large part of the stock sold in 1930 to a block of 5,000 shares, acquired at a relatively high cost, after having in previous years attributed nearly 5,000 shares to that same stock purchase. Nabors admits that this was done, admits that he knew he could not treat the same stock as sold twice, and is unable to remember how he figured that there was so much of that block

* § 7454, 1954 Code. [Ed.]

left, but he testifies that it was an honest mistake. There is no evidence that Mitchell figured on it or paid any attention to the question at all, though he knew that Nabors was attributing stock sales to the stocks having the highest costs. Mitchell's character and standing are found to be high. Similar errors which appeared in prior returns and subsequent ones might have been some evidence of a dishonest plan, but they have all been pronounced innocent except in this one instance. If, therefore, these similar errors tend to prove anything it would not be fraud but innocent mistake in this instance also.

The Board made elaborate fact findings but did not find the fact directly put in issue by the pleadings—that Mitchell knew the return was false. The general conclusion that there was fraud with intent to evade tax is explained in an opinion by the majority which seems to us to indicate that they really held that Mitchell and Nabors were grossly careless and for that reason Mitchell ought not to be absolved. To that effect we quote, 40 B.T.A. 447:

> Both petitioner and Nabors, who prepared the 1930 return for petitioner, admitted in their testimony at the hearing that they knew they had no right to use the cost basis of the same block of stock twice; they admitted that by the use of any reasonable degree of diligence they could have ascertained that most of the cost basis of the 5,000-share block had been used up in 1928 and 1929. They gave no reasonable explanation as to why they used the cost basis of the same 5,000-share block of stock twice. . . . We do not think petitioner can be guilty of such careless indifference to the basis of cost of shares of stock which he was selling and to a correct return and the oath to which he subscribed and now expect to be absolved from the consequence of his acts.

The opinion stresses Nabors' inability to explain how he came to use in 1930 the cost basis of stock mostly used up in the returns of former years, despite his testimony that it was unintentional error not deliberately made, and then proceeds: "The substance of petitioner's explanation is that he relied upon the correctness of the computations made by Nabors and that it did not occur to him to question their accuracy. In the light of all the facts in the record, we find ourselves unable to accept this explanation." The Board had found it to be a fact that: "Before signing the returns petitioner would go over the completed returns in a general way with Nabors, but he never checked the clerical computations and details which had been computed by Nabors." We cannot tell whether the Board means to say that Mitchell's negligence in not questioning Nabors' results and not checking his computations was the ground for refusing to accept his explanation, or whether they believed Mitchell knew the return was false and nevertheless filed it as true, as the Commissioner had alleged. Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Mere negligence does not establish either. *Griffiths* v. *Commissioner*, 7 Cir., 50 F.2d. 782. We think there ought to be a fact-finding that Mitchell in making this return knew or did not know its probable falsity, and that he intended to evade a tax or did not. If Mitchell, though negligent, acted in good faith and with honest intent, and it is thought that Nabors did not, but that Nabors' bad faith can be visited on Mitchell, the exact facts again ought to be found that the legal application of them may be considered. Another question that has occurred to us, but has not been argued, is

how far the Commissioner is bound by the testimony of his own witness Nabors, Nabors not being a party.

We remand the case to the Board for further fact-findings above indicated and for a redetermination, reopening it for additional evidence if either side has any to offer.

Reversed and remanded.

Note

1. The taxpayer reported about $110,000 of income for 1930; the understatement caused by using the erroneous basis was about $210,000. The Board of Tax Appeals, in refusing to accept the taxpayer's explanation, pointed out that there was another overstatement of basis in 1931 (resulting in an understatement of income of about $225,000), although that year was not before it, and that with a cost basis of about $390,000 for the securities in question the taxpayer deducted almost $940,000 in the period 1925–31. The Board said, 40 B.T.A. 424, 448 (1939):

> The Commissioner does not have to establish his determination of fraud "beyond a reasonable doubt." All that he is required to do is to make proof of his fraud charges by a preponderance of the evidence which is clear and convincing. *In re Locust Building Co.*, 299 Fed. 756. In the instant case he has proved *clearly* that in filing his income tax return for 1930 petitioner used in large part all over again as his basis of cost for Commonwealth shares sold in that year the cost basis of shares which had been largely used up in the prior years of 1928 and 1929, he has proved that petitioner knew that he had no right to do this, and that the use of such unauthorized basis of cost was largely responsible for an understatement of income for 1930 of $209,040 34. This, in the absence of any satisfactory explanation by petitioner, is convincing proof to us that petitioner's income tax return for 1930 was false and fraudulent with intent to evade tax.

On remand, the Board of Tax Appeals held, 45 B T.A. 822, 825–6 (1941).

> In compliance with the court's order that we should make "further fact-findings as indicated in the opinion of this Court," we have carefully read the opinion of the court and have reexamined the entire record of evidence. After this reexamination, we find ourselves unable to make any material changes in the findings of evidentiary fact upon which our ultimate findings were based, that "Petitioner's income tax return for the year 1930 was false and fraudulent with intent to evade tax and part of the deficiency for that year is due to fraud with intent to evade tax."
>
> As we have already stated, we construe the court's opinion to hold that as a matter of law the evidentiary facts which we have found in our prior report are not sufficient in law to sustain our ultimate finding that there was fraud for the year 1930. . . .
>
> Therefore, in respectful compliance with the opinion of the court and its mandate, we adhere to all of our findings of fact contained in *William E Mitchell*, *supra*, except the last sentence thereof, which was the ultimate finding of fact as to the year 1930 and has been quoted above. We strike out that sentence and the findings of fact which it contains and substitute in lieu thereof the following findings:
>
> > In the preparation of petitioner's income tax return for the year 1930, P H. Nabors who prepared it for him was grossly careless in using as the cost basis of 22,050 shares of Commonwealth stock sold the cost basis of 5,000 shares of Southeastern stock which petitioner had acquired at a high cost in 1927 and substantially all of which had been used in the preparation of petitioner's income tax returns for the years 1928 and 1929 as the basis of cost of stock sold by petitioner in those years. Nabors, by the use of a slight degree of diligence, could have discovered the error and could have avoided it. The

> petitioner, in signing and swearing to his 1930 income tax return as being correct, was grossly negligent in doing so. He might have, by the exercise of a slight degree of care and diligence, discovered the above mentioned error which led to a large overstatement of the cost of the shares of stock which petitioner sold and a consequent large understatement of his income for 1930. Notwithstanding their gross carelessness in these respects, neither Nabors nor Mitchell had actual knowledge that petitioner's income tax return for 1930 was false.

Therefore on these revised findings of fact and following the opinion of the court in Mitchell v. Commissioner, *supra*, we conclude that petitioner's income tax return filed for the year 1930 was not false or fraudulent with intent to evade tax and the statute of limitations has barred the deficiency and penalty determined by the Commissioner for the year 1930. This results in a holding for petitioner that there is no deficiency for the year 1930 because it is barred by the statute of limitations.* Naturally, if there is no deficiency, there can be no penalty.

2. It is not easy to generalize about what constitutes fraud so as to justify the 50 per cent penalty imposed by § 6653(b). Most fraud cases involve systematic or substantial omissions from gross income or wholly fictitious deductions or dependency claims, especially where records are not kept by the taxpayer or are falsified or destroyed. Deficiencies caused by dividends disguised as salary, improper allocations between personal and business expenses, "expensing" items that should be capitalized, depreciation and bad debt deductions, and other items involving the exercise of judgment are seldom the basis for a fraud penalty, unless the intent to evade tax is almost inescapable. Similarily, the fraud penalty is seldom asserted and even less frequently upheld in cases where the deficiency results from a transaction that complies with the letter but not with the spirit of the law. Thus, although in the *Court Holding Co.* case the Tax Court held that the sale of the property was in substance a sale by the corporation, and that the legal formalities of a liquidation and sale by the stockholders were used "only in the attempt to make the transaction appear to be other than what it was" (2 T.C. 531, 538 (1943)), it refused to find fraud. *Supra*, p. 509. On the other hand, the *Charles E. Mitchell* case, *supra*, p. 864, upheld the fraud penalty where the deficiency resulted from the deduction of loss on a purported sale of securities to the taxpayer's wife (before §§ 267(a) and (b) were enacted), although there was an abundance of paperwork in consummating the transaction. The facts are set out in the opinion of the Board of Tax Appeals, 32 B.T.A. 1093 (1935), and are summarized by the Court of Appeals, 89 F.2d 873 (2d Cir. 1937). In two somewhat comparable cases, the Board of Tax Appeals not only found no fraud but held there was no deficiency *Porter* v. *Commissioner*, 36 B.T.A. 475 (1937); *Mellon* v. *Commissioner*, *id.* 977, 1048 (with dissent, *id.* 1083).

3. See Gordon, "Income Tax Penalties," 5 *Tax L. Rev.* 131, 132–160 (1950); Spencer, "Proof of Income Tax Fraud," 2 *id.* 451 (1947). The indirect methods of calculating income considered *supra*, pp. 770–783, are much used in both civil and criminal tax fraud cases. Information leading to fraud investigations is sometimes supplied to the Treasury by disgruntled bookkeepers, embittered members of the family, divorced wives, etc.; and the Treasury may also act on such leads as news that a large sum of currency has been stolen from a mattress or clothes closet, *etc.* Section 7623 authorizes the payment of rewards to informers. See T.D. 5770, 50–1 C.B. 126; *Katzberg* v. *United States*, 36 F. Supp. 1023 (Ct. Cl 1941). But it has been held that the statutes allowing *qui tam* actions when the United States has been defrauded, 31 U.S.C. §§ 231–3, 235, are not applicable to tax frauds, at least not unless the Commissioner of Internal Revenue and the Attorney General consent to the action under Section 7401. *United States ex. rel. Roberts* v. *Western Pacific R. Co.*, 190 F.2d 243 (9th Cir. 1951).

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* Recall that § 6501(c)(1) provides that where a return is false or fraudulent with intent to evade tax, the tax may be assessed "at any time." [Ed]

5. *Criminal Fraud*

SPIES v. UNITED STATES

Supreme Court of the United States, 1943
317 U. S. 492

Mr. JUSTICE JACKSON delivered the opinion of the Court.

Petitioner has been convicted of attempting to defeat and evade income tax, in violation of Sec. 145(b) [§ 7201 of the 1954 Code]. The Circuit Court of Appeals found the assignment of error directed to the charge to the jury the only one of importance enough to notice. The charge followed the interpretation put upon this section of the statute in *O'Brien* v. *United States*, 51 F.2d 193 (C.C.A. 7), and *United States* v. *Miro*, 60 F.2d 58 (C.C.A. 2), which followed it. The Circuit Court of Appeals affirmed, stating that "we must continue so to construe the section until the Supreme Court decides otherwise." 128 F.2d 743. One Judge said that as a new matter he would decide otherwise and expressed approval of the dissent in the *O'Brien* case. As the construction of the section raises an important question of federal law not passed on by this Court, we granted certiorari.

Petitioner admitted at the opening of the trial that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either. The evidence during nearly two weeks of trial was directed principally toward establishing the exact amount of the tax and the manner of receiving and handling income and accounting, which the Government contends shows an intent to evade or defeat the tax. Petitioner's testimony related to his good character, his physical illness at the time the return became due, and lack of willfulness in his defaults, chiefly because of a psychological disturbance, amounting to something more than worry but something less than insanity.

Section 145(a)* makes, among other things, willful failure to pay a tax or make a return by one having petitioner's income at the time or times required by law a misdeameanor. Section 145(b)† makes a willful attempt in any manner to evade or defeat any tax such as his a felony. Petitioner was not indicted for either misdemeanor. The indictment contained a single count setting forth the felony charge of willfully attempting to defeat and evade the tax, and recited willful failure to file a return and willful failure to pay the tax as the means to the felonious end.

The petitioner requested an instruction that "You may not find the defendant guilty of a willful atempt to defeat and evade the income tax, if you find only that he had willfully failed to make a return of taxable income and has willfully failed to pay the tax on that income." This was refused, and the Court charged that "If you find that the defendant had a net income for 1936 upon which some income tax was due, and I believe that is conceded, if you find that the defendant willfully failed to file an income tax return for that year, if you find that the defendant willfully failed to pay the tax due on his income for that year, you may, if you find that the facts and circumstances warrant it find that the defendant will-

* § 7203, 1954 Code. [Ed.]
† § 7201, 1954 Code. [Ed.]

fully attempted to evade or defeat the tax." The court refused a request to instruct that an affirmative act was necesary to constitute a willful attempt, and charged that "Attempt means to try to do or accomplish. In order to find an attempt it is not necessary to find affirmative steps to accomplish the prohibited purpose. An attempt may be found on the basis of inactivity or on refraining to act, as well."

It is the Government's contention that a willful failure to file a return, together with a willful failure to pay the tax, may, without more, constitute an attempt to defeat or evade a tax within Sec. 145(b). Petitioner claims that such proof establishes only two misdemeanors under Sec. 145(a), and that it takes more than the sum of two such misdemeanors to make the felony under Sec. 145(b). The legislative history of the section contains nothing helpful on the question here at issue, and we must find the answer from the section itself and its context in the revenue laws.

The United States has relied for the collection of its income tax largely upon the taxpayer's own disclosures rather than upon a system of withholding the tax from him by those from whom income may be received. This system can function successfully only if those within and near taxable income keep and render true accounts. In many ways, taxpayers' neglect or deceit may prejudice the orderly and punctual administration of the system as well as the revenues themselves. Congress has imposed a variety of sanctions for the protection of the system and the revenues. The relation of the offense of which this petitioner has been convicted to other and lesser revenue offenses appears more clearly from its position in this structure of sanctions.

The penalties imposed by Congress to enforce the tax laws embrace both civil and criminal sanctions. The former consist of additions to the tax upon determinations of fact made by an administrative agency and with no burden on the Government to prove its case beyond a reasonable doubt. The latter consist of penal offenses enforced by the criminal process in the familiar manner. Invocation of one does not exclude resort to the other. *Helvering* v. *Mitchell,* 303 U.S. 391.

The failure in a duty to make a timely return, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, is punishable by an addition to the tax of 5 to 25 per cent thereof, depending on the duration of the default. Sec. 291 [§ 6651(a) of the 1954 Code]. But a duty may exist even when there is no tax liability to serve as a base for application of a percentage delinquency penalty; the default may relate to matters not identifiable with tax for a particular period; and the offense may be more grievious than a case for civil penalty. Hence the willful failure to make a return, keep records, or supply information when required, is made a misdemeanor, without regard to existence of a tax liability. Sec. 145(a). Punctuality is important to the fiscal system, and these are sanctions to assure punctual as well as faithful performance of these duties.

Sanctions to insure payment of the tax are even more varied to meet the variety of causes of default. It is the right as well as the interest of the taxpayer to limit his admission of liability to the amount he actually owes. But the law is complicated, accounting treatment of various items raises problems of great complexity, and innocent errors are numerous, as appears from the number who make overpayments. It is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest

for the delay. Secs.292 and 294 [§§ 6601(a) and 6654(a), 1954 Code]. If any part of the deficiency is due to negligence or intentional disregard of rules and regulations, but without intent to defraud, five per cent of such deficiency is added thereto; and if any part of any deficiency is due to fraud with intent to evade tax, the addition is 50 per cent thereof. Sec. 293 [§§ 6653(a) and (b), 1954 Code]. Willful failure to pay the tax when due is punishable as a misdemeanor. Sec. 145(a). The climax of this variety of sanctions is the serious and inclusive felony defined to consist of willful attempt in any manner to evade or defeat the tax. Sec. 145(b). The question here is whether there is a distinction between the acts necessary to make out the felony and those which may make out the misdemeanor.

A felony may, and frequently does, include lesser offenses in combination either with each other or with other elements. We think it clear that this felony may include one or several of the other offenses against the revenue laws. But it would be unusual and we would not readily assume that Congress by the felony defined in Sec. 145(b) meant no more than the same derelictions it had just defined in Sec. 145(a) as a misdemeanor. Such an interpretation becomes even more difficult to accept when we consider this felony as the capstone of a system of sanctions which singly or in combination were calculated to induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency.

The difference between willful failure to pay a tax when due, which is made a misdemeanor, and willful attempt to defeat and evade one, which is made a felony, is not easy to detect or define. Both must be willful, and willful, as we have said, is a word of many meanings, its construction often being influenced by its context. *United States* v. *Murdock*, 290 U.S. 389. It may well mean something more as applied to nonpayment of a tax than when applied to failure to make a return. Mere voluntary and purposeful, as distinguished from accidental, omission to make a timely return might meet the test of willfulness. But in view of our traditional aversion to imprisonment for debt, we would not without the clearest manifestation of Congressional intent assume that mere knowing and intentional default in payment of a tax, where there had been no willful failure to disclose the liability, is intended to constitute a criminal offense of any degree. We would expect willfulness in such a case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.

Had Sec. 145(a) not included willful failure to pay a tax, it would have defined as misdemeanors generally a failure to observe statutory duties to make timely returns, keep records, or supply information—duties imposed to facilitate administration of the Act even if, because of insufficient net income, there were no duty to pay a tax. It would then be a permissible and perhaps an appropriate construction of Sec. 145(b) that it made felonies of the same willful omissions when there was the added element of duty to pay a tax. The definition of such nonpayment as a misdemeanor, we think, argues strongly against such an interpretation.

The difference between the two offenses, it seems to us, is found in the affirmative action implied from the term "attempt," as used in the felony subsection. It is not necessary to involve this subject with the complexities of the common-law "attempt." The attempt made criminal by this statute does not consist of conduct that would culminate in a more serious crime but for some impossibility of completion or interruption or frustration. This is an independent crime, complete in

its most serious form when the attempt is complete, and nothing is added to its criminality by success or consummation, as would be the case, say, of attempted murder. Although the attempt succeed in evading tax, there is no criminal offense of that kind, and the prosecution can be only for the attempt. We think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues, Congress intended some willful commission in addition to the willful omissions that make up the list of misdemeanors. Willful but passive neglect of the statutory duty may constitute the lesser offense, but to combine with it a willful and positive attempt to evade tax in any manner or to defeat it by any means lifts the offense to the degree of felony.

Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation. Nor would we by definition constrict the scope of the Congressional provision that it may be accomplished "in any manner." By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.

In this case there are several items of evidence apart from the default in filing the return and paying the tax which the Government claims will support an inference of willful attempt to evade or defeat the tax. These go to establish that petitioner insisted that certain income be paid to him in cash, transferred it to his own bank by armored car, deposited it, not in his own name but in the names of others of his family, and kept inadequate and misleading records. Petitioner claims other motives animated him in these matters. We intimate no opinion. Such inferences are for the jury. If on proper submission the jury found these acts, taken together with willful failure to file a return and willful failure to pay the tax, to constitute a willful attempt to evade or defeat the tax, we would consider conviction of a felony sustainable. But we think a defendant is entitled to a charge which will point out the necessity for such an inference of willful attempt to defeat or evade the tax from some proof in the case other than that necessary to make out the misdemeanors; and if the evidence fails to afford such an inference, the defendant should be acquitted.

The Government argues against this construction, contending that the milder punishment of a misdemeanor and the benefits of a short statute of limitation should not be extended to violators of the income tax laws such as political grafters, gamblers, racketeers, and gangsters. We doubt that this construction will handicap prosecution for felony of such flagrant violators. Few of them, we think, in their efforts to escape tax, stop with mere omission of the duties put upon them by the statute, but if such there be, they are entitled to be convicted only of the offense which they have committed.

Reversed.

Note

First Trust & Savings Bank v. *United States*, 206 F.2d 97 (8th Cir. 1953), involved a taxpayer who pleaded guilty and was fined on a charge of willfully failing to file a return under § 7203. A 50 per cent civil fraud penalty was assessed, but the Court of Appeals held that a willful failure to file a return was not sufficient to permit an assessment under § 6653(b), although it would justify the 25 per cent addition of § 6651(a). Relying on the *Spies* case, the court, one judge dissenting, said:

> The distinction between the lesser and the graver derelictions which govern the larger and the smaller civil additions to tax is of exactly the same character as that found by the Supreme Court [in the *Spies* case] in respect to the criminal penalties. Manifestly wilful failure to file returns may have the same effect on the collection of the revenue as an attempt to evade a tax. But Congress makes the difference on the civil side as it does on the criminal side, between the taxpayer whose deficiencies of tax are due to (or caused by) his affirmative commission of fraud and the one whose deficiencies are due to willful omission to make return. That omission justifies the addition of 5 per cent up to 25 per cent of the deficiencies found against the taxpayer but does not afford any basis for the addition of 50 per cent to his deficiencies. Only the commission of acts of fraud with intent to evade tax to which "the deficiencies are due" (or which bring about the deficiencies) affords a basis for the 50 per cent addition to tax. (206 F.2d at 100–101.)

The House version of the 1954 Code made a felony of willful failure to file a tax return, but the Senate refused to agree, and the Code as enacted preserves the distinction of the *Spies* case and the 1939 Code.

UNITED STATES v. BEACON BRASS CO.

Supreme Court of the United States, 1952
344 U. S. 43

Mr. Justice Minton delivered the opinion of the Court.

On March 16, 1951, a one-count indictment was returned in the United States District Court for the District of Massachusetts against the appellees, Beacon Brass Company, a corporation, and Maurice Feinberg, its president and treasurer. The indictment charged that in violation of § 145 (b) [§ 7201 of the 1954 Code], the appellees had willfully attempted to evade taxes by making false statements to Treasury representatives on October 24, 1945, "for the purpose of supporting, ratifying, confirming and concealing the fraudulent and incorrect statements and representations made in the corporate tax return of said Beacon Brass Co., Inc., for the fiscal period ending October 31, 1944, filed on or about January 5, 1945 . . . ." Section 145(b) provides in pertinent part:

> [A]ny person who willfully attempts *in any manner* to evade or defeat any tax imposed by this chapter or the payment thereof, shall, *in addition to other penalties provided by law*, be guilty of a felony. . . ." [Emphasis supplied.]

The six-year limitation period, I.R.C. § 3748 (a) (2),* applicable to offenses under this statute, had expired on a charge for filing a false tax return in January 1945, but it had not expired on a charge of making false statements to Treasury employees in October 1945. The District Court viewed the indictment as charging the separate crimes of filing a false return and making subsequent false statements to Treasury representatives, and dismissed the indictment as duplicitous.

* § 6531(2) of the 1954 Code. [Ed.]

On September 14, 1951, a second indictment was returned against the appellees which repeated the charge that in violation of § 145(b) they

did wilfully and knowingly attempt to defeat and evade a large part of the taxes due and owing by the said corporation . . . by making certain false and fraudulent statements and representations, at a hearing and conference before representatives and employees of the United States Treasury Department, on or about October 24, 1945. . . .

Reference to the allegedly false return filed in January 1945 was omitted, and instead it was charged that the false statements were made "for the purpose of concealing additional unreported net income . . . ."

Section 35(A) of the Criminal Code, 18 U.S.C. (Supp. V) § 1001, makes it unlawful to "knowingly and willfully . . . make . . .any false or fraudulent statements or representations . . . in any matter within the jurisdiction of any department or agency of the United States . . . ." Obviously, at the times of the indictments here, the three-year limitation period, 18 U.S.C. (Supp. V) § 3282, for violations of this statute had expired as to statements made in October 1945. The District Court concluded that since § 35(A) deals specifically with false statements, Congress must be persumed to have intended that the making of false statements should be punishable *only* under § 35(A). Therefore, the District Court, 106 F. Supp. 510, dismissed the indictment on the ground that it failed to charge an offense under I.R.C. § 145(b).

We have before us two statutes, each of which proscribes conduct not covered by the other, but which overlap in a narrow area illustrated by the instant case. At least where different proof is required for each offense, a single act or transaction may violate more than one criminal statute. *United States* v. *Noveck,* 273 U.S. 202, 206, 47 S. Ct. 341, 342, 71 L. Ed. 610; *Gavieres* v. *United States,* 220 U.S. 338, 31 S. Ct. 421, 55 L. Ed. 489. Unlike § 35(A), § 145(b) requires proof that the false statements were made in a willful effort to evade taxes. The purpose to evade taxes is crucial under this section. The language of § 145(b) which outlaws willful attempts to evade taxes "in any manner" is clearly broad enough to include false statements made to Treasury representatives for the purpose of concealing unreported income. *Cf. Spies* v. *United States,* 317 U.S. 492, 499, 63 S.Ct. 364, 368, 87 L. Ed. 418. The question raised by the decision below is whether by enacting a statute specifically outlawing all false statements in matters under the jurisdiction of agencies of the United States, Congress intended thereby to exclude the making of false statements from the scope of § 145(b).

We do not believe that Congress intended to require the tax-enforcement authorities to deal differently with false statements than with other methods of tax evasion. By providing that the sanctions of § 145(b) should be "in addition to other penalties provided by law," Congress recognized that some methods of attempting to evade taxes would violate other statutes as well. See *Taylor* v. *United States,* 9 Cir., 179 F.2d 640, 644. Moreover, since no distinction is made in § 35(A) between written and oral statements, the reasoning of the court below would be equally applicable to false tax returns which are, of course, false written statements. But the Courts of Appeals have uniformly applied § 145(b) to attempts to evade taxes by filing false returns. *E. g., Gaunt* v. *United States,* 1 Cir., 184 F.2d 284, 288; *Taylor* v. *United States, supra,* 179 F.2d at pages 643-644. Further sup-

port for our conclusion can be found in *United States* v.*Noveck, supra,* where this Court rejected the contention that the enactment of § 145(b) impliedly repealed the general perjury statute insofar as that statute applied to false tax returns made under oath. *Cf. United States* v. *Gilliland,* 312 U.S. 86, 93, 95-96, 61 S. Ct. 518, 522, 523, 85 L. Ed. 598. Finally, the enactment of other statutes expressly outlawing false statements in particular contexts, *e. g.,* 18 U.S.C. (Supp. V) §§ 1010, 1014, negates the assumption—which was the foundation of the decision of the court below—that Congress intended the making of false statements to be punishable only under § 35(A).

The appellees contend that the acts charged constitute only one crime of tax evasion which was complete when the allegedly false tax return was filed. On the basis of this contention, appellees seek to sustain the decision below on the grounds that the six-year statute of limitations had run, and that the dismissal of the first indictment is *res judicata* and a bar to the second indictment for the same offense. We do not consider these questions because our jurisdiction on this appeal is limited to review of the District Court's construction of the statute in the light of the facts alleged in the indictment. 18 U.S.C. (Supp. V) § 3731; *United States* v. *Borden Co.,* 308 U.S. 188, 206-207, 60 S. Ct. 182, 191-192, 84 L. Ed. 181.

The judgment of the District Court is reversed, and the cause is remanded for further proceedings not inconsistent with this opinion.

Reversed.

MR. JUSTICE BLACK is of the opinion that the District Court reached the right result and would *affirm* its judgment.

TESTIMONY OF J. F. WINKLE, ASSISTANT COMMISSIONER (OPERATIONS), ON PROCEDURE IN FRAUD CASES

Hearings on Treasury-Post Office Departments Appropriations for 1954
Subcommittee of House Committee on Appropriations
83d Cong., 1st Sess., March 31, 1953, pp. 703–5

MR. WINKLE. The routing of a fraud case is somewhat different. Fraud cases can arise generally in one of two ways, either as the result of an examination which was originally undertaken as a routine examination or as the result of a tip or lead or information of some kind coming to the attention of the Intelligence Division.

Taking the normal type of case where the revenue agent working out of the Audit Division is undertaking an examination of the taxpayer's books and records and comes upon information during the course of that examination which suggests the existence of fraud, the instructions are that the agent is to immediately suspend his investigation at that point and prepare a preliminary report in which he would recite very carefully the information he has developed that suggests to him that there may be fraud in the case. Then that report is referred up through channels to the head of the Audit Division, and in turn it is sent across to the head of the Intelligence Division in order that the information may be evaluated with a view to determining whether or not the Intelligence Division would wish to join in a joint investigation of the case. If, after evaluation of the information in the Intelligence Division, it is concluded that the evidence the agent has developed

is not sufficiently indicative of fraud to warrant the assignment of a special agent to the case, the case is referred back to the Audit Division with the suggestion that it be developed along routine lines, but that if any further indications of fraud appear the matter should again be referred to the Intelligence Division.

If, on the other hand, the Intelligence Division considers that the indications of fraud that the agent has dug up are sufficient to warrant the assignment of a trained special agent to the case, the special agent is assigned, and thereafter the case is worked jointly by the revenue agent who is responsible for the audit, or the technical features of the case, and the special agent who is responsible for the criminal, or fraud features of the case.

At the completion of the investigation at the present time there are two reports prepared, one the technical report and the other the fraud report. We are hoping that we will ultimately get to the point where those two reports can be combined. We have not gotten to it as yet.

The routing of that report depends upon what recommendation is made. If the recommendation is that no criminal prosecution be instituted but that the 50 percent civil fraud penalty be asserted, the case is then referred back to the audit division, where the civil liability, plus the 50 percent fraud penalty, is settled.

If the taxpayer, of course, is in disagreement in that type of situation, then the case follows the channels [for administrative settlement], even though there is a 50 percent civil fraud penalty feature in the case.

If, on the other hand, criminal prosecution is recommended, the case cannot be closed out at the director's office level; that is to say, the procedures are such that once criminal prosecution is recommended, neither the head of the Intelligence Division nor the Director of Internal Revenue can change that recommendation. They can express themselves on the recommendation, but the instructions are that the case must proceed up to the district commissioner's level, where it is turned over to the assistant district commissioner for intelligence.

In the meanwhile, of course, the taxpayer has been given an opportunity for conferences with appropriate officials at the director's level.

When the case reaches the assistant district commissioner—intelligence, it is very carefully examined, and if the intelligence division at the district commissioner's level agrees to the recommendation, it is then referred over to the office of the district counsel, where the enforcement counsel, who is a part of the district counsel setup, proceeds to examine the case, and if he is in agreement that prosecution should be recommended, then the case is sent directly from the district counsel's office to the Department of Justice here in Washington.

Thereafter, the decision as to whether they should go ahead with prosecution is up to the Department of Justice. If, on the other hand, the assistant district commissioner—intelligence and the district counsel conclude that no prosecution is in order, the case is then channeled on down for civil settlement.

If there is a disagreement as between the district counsel and the assistant district commissioner—intelligence, the case is then sent to Washington where a decision is jointly made as between the head of the Intelligence Division in Operations and the enforcement counsel in the Chief Counsel's office.

The final decision, however, under existing orders as to whether prosecution will be instituted is that of the Chief Counsel's office.

That, very briefly, is the procedure followed in the processing of a tax fraud case under the new organization plan.

Mr. Gary. You say that when a fraud case is turned over to the Department of Justice in Washington, it determines whether there is to be prosecution?

Mr. Winkle. That is correct, sir.

Mr. Gary. And then they send it down to the district?

Mr. Winkle. To the United States attorney.

Mr. Gary. Does the district attorney have any discretion in the matter at all?

Mr. Winkle. We have had numerous cases returned to us from the Department of Justice. In some of them there is an indication that the United States attorney, after evaluating the evidence in the case, did not feel that there was a sufficient certainty of conviction to warrant going ahead.

Mr. Sieminski. In the event no ground for prosecution exists, what notification does the Director of Internal Revenue receive, if any, from the Department of Justice?

Mr. Winkle. If I understand your question, Congressman, it is if the Department of Justice concludes that they will not go ahead with prosecution, what notification does the director's office receive?

Mr. Sieminski. Yes.

Mr. Winkle. We are notified as to the reasons why the Department does not feel that it should go ahead. As a matter of fact, not too long ago we had a conference with Mr. Holland, the Assistant Attorney General in charge of the Tax Division, and among other things we discussed the matter of our being advised as specifically as possible in those cases because, of course, we want to use that for management and analysis purposes.

STATEMENT OF SECRETARY OF THE TREASURY VINSON REGARDING VOLUNTARY DISCLOSURE OF TAX LIABILITY

Washington Post, August 21, 1945
Reprinted in Hearings before Congressman King's Subcommittee
of House Committee on Ways and Means
82d Cong., 2d Sess. (1952), pp. 143–4

No honest American need fear this drive against tax evaders. No one is going to jail for an honest mistake in filling out his tax return. Treasury policy even permits the willful evader to escape prosecution if he repents in time. The Commissioner of Internal Revenue does not recommend criminal prosecution in the case of any taxpayer who makes a voluntary disclosure of omission or other misstatement in his tax return or of failure to make a tax return. Monetary penalties may be imposed for delinquency, for negligence and for fraud, but the man who makes a disclosure before an investigation is under way protects himself and his family from the stigma of a felony conviction. And there is nothing complicated about going to a collector or other revenue officer and simply saying,"There is something wrong with my return and I want to straighten it out."

A great many people are taking advantage of this opportunity to get right with their Government. During the past 2 months an average of 1,000 persons in the United States have voluntarily filed amended returns. I do not intimate that all of these persons have been willful tax evaders. In the normal course of events Americans file such delinquent and amended returns as they discover their own lapses. But I venture to predict that the 3 million dollars added revenue that the Treasury now receives each week as a result of these delinquent and amended re-

turns, will grow as our tax-evasion agents get their campaign into full swing. Certainly any tax evader, who has not yet seen the light would be well advised to take corrective action while there is yet time to square himself with his conscience and his Government without suffering the further indignity of public indictment, trial, and punishment.

STATEMENT OF J. P. WENCHEL, CHIEF COUNSEL OF THE BUREAU OF INTERNAL REVENUE

Address to Tax Executives Institute, May 14, 1947
Reprinted in 1952 P-H Fed. Tax Serv. ¶ 18,604-A

The making of a voluntary disclosure is a simple thing. The taxpayer or his legal agent can go before any official of the Bureau of Internal Revenue or any of its field offices—whether it is the collector, a deputy collector, a revenue agent, a special agent, or any other responsible Treasury officer. There is no special form for making the disclosure. The simple statement that "I have filed false tax returns and I want to make the Government whole," would constitute a complete disclosure. Of course, it is usually best to present an amended return or other written document as evidence of the disclosure. If possible, the disclosure should be accompanied by payment of the tax which is known to be due, but this is not a prerequisite.

What kind of people make disclosures? They are all kinds. Some are people who are honestly repentent. Others are people who would rather sacrifice their ill-gotten gains than to go to jail. Some are small people. Others are large corporations.

We had a good illustration recently in the Midwest. A large produce concern that had enriched itself on war contracts to help feed the Army, came to see the light. It made a complete statement to our local officials and paid $1,765,000 in taxes, interest, and civil penalties in order to clear its record and to keep its officers out of jail.

We have had voluntary disclosures from black-market meat and car dealers. We have had similar repentances from people in all walks of life. Of the $3,000,000,000 collected from taxpayers within the past 18 months as a result of the current drive against tax evaders, $500,000,000 has been paid on voluntary disclosures.

Now we have said that in order to be considered voluntary a disclosure must be made before we have initiated an investigation in the case. Therefore, it is essential that we define "the initiation of an investigation."

The mere record of a name does not mean that an investigation has been initiated. The fact is that examining officers throughout the country have thousands of names or possible leads. To deny the existence of a voluntary disclosure merely because we have a name would be comparable to regarding the telephone book as a dossier of tax evaders.

An investigation is initated when a special agent, an internal revenue agent, a deputy collector, or other Bureau officer, is assigned a return for examination, or where an investigating officer has requested advice of appropriate officers of the Bureau with respect to the filing of a return or the payment of taxes.

The time of disclosure and the time an investigation begins are, therefore, matters which can be ascertained with complete objectivity and certainty, thus

protecting both the Government and the taxpayer from decisions based on guesswork or other vague circumstances. To assure adherence to this principle, the Bureau stands ready at all times where a dispute may arise as to the time of a disclosure and the time an investigation was initiated to open its records in that regard.

We are not concerned with the motivating force behind an individual's deciding to come in and talk to us about his evasion. If he "gets religion" before we have done anything, he will not be prosecuted.

Before we leave this subject, let me make one thing clear. When we excuse a man from criminal prosecution because of his voluntary disclosure, we are not in any sense condoning his action. Nor are we letting anyone off easy. At the outset, I mentioned that there are two kinds of fraud, criminal and civil. Voluntary disclosure excuses a man from criminal punishment, but it does not excuse him from the civil penalties. Therefore, the public revenues and the public conscience are both protected by this policy.

In excusing the man from criminal prosecution, we are merely taking a sensible step to produce the revenue called for by law with the minimum cost of investigation. The man who makes a voluntary disclosure saves us a lot of money in investigating. In return, we can spare him a term in jail. This is good business from his standpoint and it is good business from the Government's standpoint.

STATEMENT OF SECRETARY OF THE TREASURY SNYDER ON ABANDONMENT OF VOLUNTARY DISCLOSURE POLICY

Treasury Department Information Service
Release No. S-2930, January 10, 1952
55-2 P-H Federal Tax Service ¶ 18,604-A

Secretary Snyder announced today that the Treasury Department has abandoned the policy under which criminal prosecution has not been recommended in cases where taxpayers made voluntary disclosures of intentional violation of the internal-revenue laws prior to the initiation of the investigation by the Bureau of Internal Revenue. This action was recommended by Commissioner Dunlap. In connection with this change of policy, the Secretary issued the following statement:

"While it has been the long-established policy of the Treasury Department to refrain from recommending criminal prosecution where taxpayers make voluntary disclosure of intentional tax evasion prior to the initiation of an investigation by the Bureau of Internal Revenue, it has been concluded that such policy will no longer be followed. Litigation in the courts in recent years has illustrated the controversial nature of the question as to what constitutes a true voluntary disclosure in fact. In the administration of the policy it has been difficult and at times impossible to ascertain whether the disclosure was made because the taxpayer realized he was under investigation or whether the disclosure was in fact voluntary and in reliance on the immunity held out by the policy.

"The intensified enforcement activities of the Bureau's special tax fraud drive and racket squads throughout the country are ferreting out the willful tax evaders,

and resulting in recovery of the additional taxes and penalties due the Government. It is the policy of the Treasury Department to recommend criminal prosecution in every case where the facts and circumstances warrant that action."

Note

1. A disclosure made before the statement of Chief Counsel Wenchel, *supra,* was held to be "voluntary" (in a motion to suppress evidence) as the term was used by Secretary Vinson, *supra,* because the taxpayer did not know he was under investigation, although his returns had been assigned for investigation by a special agent and both he and a customer had already been questioned. *In re Liebster,* 91 F. Supp. 814 (E.D. Pa. 1950). In *United States* v. *Levy,* 99 F. Supp. 529 (D. Conn. 1951), it was held that under the later statement of Chief Counsel Wenchel, a disclosure made after an assignment of the case for routine investigation was too late, despite the taxpayer's lack of knowledge of the investigation. (The Court suggested adoption of a policy of notifying taxpayers when a return is assigned for examination that any disclosure to escape prosecution must be made within 60 days.) See also *Lapides* v. *United States,* 215 F.2d 253 (2d Cir. 1954). In *United States* v. *Weisman,* 78 F. Supp. 979 (D. Mass. 1948), a disclosure was held not to be timely when an investigation of a transaction between the taxpayer and a third party was already under way, although the taxpayer himself was not yet under suspicion. See Jones, "Voluntary Disclosure Policy of the Treasury Department," 6 *Tax L. Rev.* 329 (1951). There were a number of cases in which the taxpayer claimed, and the agent disputed, the making of an oral disclosure, and always present was the possibility of collusion by an agent in pre-dating a memorandum setting out a voluntary disclosure.

2. The American Bar Association's Section on Taxation has recommended the reinstatement of "a voluntary disclosure policy of a type which is reasonable and practicable from the standpoint of the problems of the Treasury Department and of the taxpayers." Mr. Albert E. Arent, formerly Chairman of this group's Committee on Procedure in Fraud Cases, made this defense of a procedure for voluntary disclosure before the "King Committee":

> Many of us view with regret the abandonment of what is known as the voluntary disclosure policy. We think it is a casualty of the Bureau's lack of candor and explicitness in defining what constitutes a voluntary disclosure for purposes of obtaining immunity from prosecution. Although the task is not without its difficulties, I see no reason why the Bureau could not issue regulations precisely describing at what procedural stage an investigation begins and stating exactly what the taxpayer must do to win immunity from prosecution. Since the policy was the Bureau's own creation, it could set up whatever safeguards it needed to prevent taxpayers from taking unfair advantage of the policy and, at the same time, it could establish guideposts so that honest attorneys and frightened or reformed taxpayers could take advantage of the policy with confidence. Under such a policy, properly administered, hundreds of thousands of dollars will be paid into the Treasury which would otherwise escape detection. We are all aware that no matter how many special agents the Government employs it can have only sample enforcement. Scores, if not hundreds, escape for each one that gets caught. To collect its taxes, therefore, the Government must rely not only upon its enforcement machinery but primarily upon the integrity of the taxpaying public and, secondly, upon its fear. In my opinion, the threat of prosecution is one of the most effective sanctions available—one that should not be weakened for the sake of any immediate increase in revenue, for in the long run the Government would lose. I do not believe, however, that the sanction is weakened by an opportunity for voluntary disclosure if it is known that such disclosure is futile after the Government has begun investigating a taxpayer, especially since a person making voluntary disclosure usually ends up paying not only the full tax due but also

interest and a 50-per cent fraud penalty. It does not matter whether the taxpayer makes disclosure because he learns that a customer or a patient of his is being investigated and the trail may lead to him or whether he gets religion. We are dealing not with a moral question but with a practical problem of raising revenue. We know that even when it has such collateral leads the Bureau can follow through and catch up with only a small portion of those who would take advantage of an opportunity to make voluntary disclosure.

Because of the mistakes and transgressions of a small minority of our public officials, we find an increasing timidity among honest and able public officials with respect to assuming responsibility for difficult decisions. This could lead to a bureaucratic paralysis which would seriously harm the effectiveness of our Government and grossly injure all of us who have to deal with our Government—whether as taxpayers, as businessmen, or as servicemen The abandonment by the Treasury of its voluntary disclosure policy, and perhaps, too, of its recognition of health as an element of decision in the processing of a tax-fraud case, is not the constructive or courageous way out. The Bureau should be encouraged to grapple with its difficult problems and not to run from them. (Hearings, Subcommittee of House Ways and Means Committee, 82d Cong., 2d Sess., 1952, p. 243.)

3. Proposals for notifying taxpayers when an investigation has begun have been criticized by representatives of the Bureau because in fraud cases the taxpayer might thereupon proceed to alter or destroy records, intimidate witnesses, or obstruct the investigation in other ways. See testimony of R. C. Schwartz, Penal Division, Bureau of Internal Revenue, before the "King Committee." Hearings, p. 157.

4. See generally Wallace, "Penalties and Prosecutions for Evasion of the Federal Income Tax," 1 *Tax L. Rev.* 329 (1946), Lyon, "The Crime of Income Tax Fraud: Its Present Status and Function," 53 *Col. L. Rev.* 476 (1953), American Bar Association Section on Taxation, *Symposium on Procedure in Tax Fraud Cases* (1951); Murphy, "Criminal Income Tax Evasion," 48 *Northwestern U. L. Rev.* 317 (1953); Winer, "An Appraisal of Criminal and Civil Penalties in Federal Tax Evasion Cases," 33 *B.U.L. Rev.* 387 (1953).

Part II

FEDERAL ESTATE AND GIFT TAXATION

INTRODUCTION

The taxes that are the subject of Part II of this book are not important sources of government revenue. The federal government has collected $40-70 billion in taxes annually since World War II; of this amount, estate and gift taxes have yielded only between five and nine hundred millions a year. With heavy commitments for arms and foreign aid in prospect for some time to come, total tax levies are not likely to be greatly reduced. But estate and gift taxes will continue to produce only a modest part of the total, and any future increases in total collections are likely to be accompanied by a decrease in the relative contribution of the estate and gift taxes. The revenue from these taxes is dwarfed not only by the enormous yields from the taxation of personal and corporate income; it is meager even by comparison with the federal taxes on alcohol and tobacco. Before World War II, estate and gift taxes contributed a larger share of total federal tax revenue than they have since, their proportion during the fiscal period 1935–1941 being about 7 per cent of the total. But during that period, total federal tax collections averaged only $5 billion per year—a low level, which, unhappily, is not likely ever to be approached again.

Raising the rates would increase the yield of the federal estate and gift taxes, but no foreseeable increase would convert them into serious competitors of the federal income tax. In fact, even if a draconic Congress were to transmute the federal estate tax into an escheat measure, taking 100 per cent of the net estate, its yield would still be only a small part of total tax revenues. Estate tax returns filed in 1951, for example, reported net estates (gross estates less allowable deductions for funeral and administration expenses, debts, charitable bequests, and so on) aggregating $3.7 billion. Outright confiscation of these estates, then, would have produced—along with a group of new Congressmen, no doubt—only about 8 per cent of total federal expenditures for that year. If the present exemption of $60,000 per estate had been allowed by the hypothetical Congress, the yield would have been reduced to about $2.2 billion. In the same year, federal income and excess profits taxes produced about $37 billion in revenue, and the federal taxes on alcohol and tobacco a total of more than $3.9 billion. It is not surprising, then, that when cold and hot wars have created a need for more billions in government revenue in recent years, Congress has raised these funds by increasing the income tax rates, rather than by changing the estate and gift tax schedules.

State governments, too, have looked elsewhere than to death and gift taxes to satisfy the need for funds. During the fiscal year 1954, for example, death and gift taxes produced for the states only about $250 million out of about $11 billion in tax collections, or about 2 per cent of the total; in only four states (Connecticut, Delaware, New Jersey, and Pennsylvania) did the yield from these taxes represent 5 per cent or more of total collections. Their yield was relatively somewhat

more important before World War II, but even then they ranked much behind collections from state taxes on retail sales, gasoline, tobacco, alcoholic beverages, and motor vehicles.

The raising of revenue, of course, is not the only function of taxation. Indeed, some taxes are not expected to produce any revenue; if the Treasury reported a sharp increase in the yields from the taxes on adulterated and renovated butter, filled cheese, firearms, or narcotics, Congress would not applaud but rather would start an investigation.

Unconstrained by a conception of taxation for revenue only, contemporary economists have stressed the contribution that taxes may make toward stabilizing the national economy.

In this view, tax policy may be a counter-cyclical weapon, deliberately employed to combat manic-depressive fluctuations of the business cycle. Thus when inflation threatens, taxation can be used to sop up excess consumer purchasing power, to discourage investment, or to encourage savings. By reducing the demand for goods and services, such tax collections would serve to moderate or prevent inflation of the price level. When unemployment develops, on the other hand, taxes can encourage spending and discourage saving, thus increasing public demand in order to bring idle men and machines back into production. The federal personal income tax is suited to these tasks, since the progressive rate schedule acts to increase rapidly the financial pressure on the taxpayer during a "boom," while it works equally as rapid to diminsh that pressure during a "bust." This characteristic has been termed "cycle-sensitivity" or, because the tax responds automatically (without even a change in the prescribed rates) to changes in income, "built-in flexibility."

Just as estate and gift taxes lag far behind the income tax in the power to raise revenue, so they are far less promising as counter-cyclical instruments. To be sure, decedents' estates vary in value with changes in the price level, and therefore the progressive federal estate tax possesses a degree of "built-in flexibility." If gifts are larger during "booms," as seems likely, the gift tax yields should rise and fall with the business cycle. But the impact of gifts and inheritance on the nation's total pattern of consumption, saving, and investment cannot be great, the force that carries the threat of price inflation during full employment is the generally increased national income, not the fact that the wealth of a few persons may have been augmented to some extent by gift or inheritance. The personal income tax, with stepped-up rates if necessary, can accomplish infinitely more in the way of checking inflation than even a confiscatory estate tax.

Whatever slight counter-cyclical pressure the estate tax might exert would not be felt promptly (as in the case of an income tax withheld at the source, for example), but rather would follow sluggishly, because of an almost inevitable delay in computing and collecting the tax. Moreover, abrupt alteration of the estate tax rates discriminates unfairly among taxpayers, since the tax liability falls according to the accident of the date of death. To be sure, sharp changes in income tax rates penalize those taxpayers whose earning patterns happen to be abnormal, but these inequities are proportionately less serious than in the case of the estate tax. The incomes of most taxpayers rise and fall with the business cycle, but inheritance—if it comes at all—is likely to come only once or twice in a

lifetime. An increase in the gift tax rate, on the other hand, would lose much of its effectiveness if taxpayers postponed the making of gifts in anticipation of a rate reduction in a downswing of the business cycle. Although an increase in income tax rates can also be vitiated to some extent by postponing or accelerating certain transactions, the danger is not as great because taxpayers generally have less control over income items than over donative transfers. It is not surprising, then, that economists have not regarded estate and gift taxes as helpful tools for stabilizing the economy at a high level of employment and production.[1]

What then is the function of these taxes, which neither raise substantial amounts of revenue nor serve to stabilize the nation's economy? The answer may be found in the history of estate and gift taxation, for the proponents of these taxes have not sought to conceal their aims.

In a message to Congress in 1906 advocating a progressive inheritance tax, President Theodore Roosevelt said:

> . . . [T]he prime object should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate.[2]

A little earlier, in a speech on laying the cornerstone of the House of Representatives office building, he had been a bit more detailed

> . . . I feel that we shall ultimately have to consider the adoption of some such scheme as that of a progressive tax on all fortunes, beyond a certain amount, either given in life or devised or bequeathed upon death to any individual—a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual; the tax, of course, to be imposed by the National and not the State Government. Such taxation should, of course, be aimed merely at the inheritance or transmission in their entirety of those fortunes swollen beyond all healthy limits.[3]

The suggestion was greeted with enthusiasm by the liberal and radical press, and with dismay and predictions of doom by more conservative commentators. Somewhat earlier, Andrew Carnegie had announced his support of increased inheritance taxation in a magazine article that attracted widespread attention, including a cordial compliment from John D. Rockefeller. Carnegie said:

> The growing disposition to tax more and more heavily large estates left at death is a cheering indication of the growth of a salutary change in public opinion. The State of Pennsylvania now takes—subject to some exceptions—one tenth of the property left by its citizens. The budget presented in the British Parliament the other day proposes to increase the death duties, and, most significant of all, the new tax is to be a graduated one. Of all forms of taxation this seems the wisest. Men who continue hoarding great sums all their lives, the proper use of which for public ends would work good to the community from which it chiefly came, should be made to feel that the community, in the form of the State, cannot thus be deprived of its proper share. By taxing estates heavily at death the State marks its condemnation of the selfish millionaire's unworthy life.

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[1] But see Bloch, "Economic Objectives of Gratuitous Transfer Taxation," 4 *Nat. Tax J.* 139 (1951).

[2] 17 *Roosevelt's Works* (Memorial edition, Charles Scribner's Sons, New York, N.Y., 1925) 401, 434.

[3] 18 *ibid.* 571, 578.

It is desirable that nations should go much further in this direction. Indeed, it is difficult to set bounds to the share of a rich man's estate which should go at his death to the public through the agency of the State, and by all means such taxes should be graduated, beginning at nothing upon moderate sums to dependents, and increasing rapidly as the amounts swell, until of the millionaire's hoard, as of Shylock's, at least

The other half
Comes to the privy coffer of the State.

This policy would work powerfully to induce the rich man to attend to the administration of wealth during his life, which is the end that society should always have in view, as being by far the most fruitful for the people. Nor need it be feared that this policy would sap the root of enterprise and render men less anxious to accumulate, for, to the class whose ambition it is to leave great fortunes and be talked about after their death, it will attract even more attention, and, indeed, be a somewhat nobler ambition, to have enormous sums paid over to the State from their fortunes.[4]

Although these statements of Roosevelt and Carnegie, like subsequent defenses of our existing estate and gift taxes, were undoubtedly a response to the "robber baron" era of American history, they did not sound a wholly new note. Throughout the nineteenth century death taxation had been advocated primarily as an instrument for the equalization of wealth. Indeed, Jeremy Bentham had used the very phrase "equalization of fortunes" [5] and John Stuart Mill had suggested "as a possible mode of restraining the accumulation of large fortunes in the hands of those who have not earned them by exertion, a limitation of the amount which any one person should be permitted to acquire by gift, bequest, or inheritance." [6] This drive toward equalization has drawn its strength from several sources: a moralistic abhorrence of idleness or profligacy, thought to be a result of unearned wealth; the belief that the economic well-being of the community requires that all its members earn their own livings; and an ethical insistence upon equality of opportunity. No doubt these sources, and others, have contributed in different degrees to the views of individual supporters of gift and estate taxation.

Although the history of the relationship of democratic thinking to the institution of inheritance is still to be written, one may surmise that much of the popular support for death taxes in our country has stemmed from the "democratic dogma," no doubt with a strong tinge of puritanical disapproval of idleness. The burgeoning of state inheritance taxes in the eighties and nineties of the last century must have been an offshoot of agrarian and labor unrest, and, though the present federal estate tax was adopted in 1916 under the pressure of war, its roots and later history are both bound up with the democratic dream of equal opportunity for all. Even before the freedom to *amass* a fortune was challenged by the income tax, there were doubts whether such a fortune should be *passed along* intact to those who had not earned it. American fiction has often glorified the poor boy who became the head of an enterprise by marrying the boss's daughter, but there is no record of similar sympathy for the boss's son who took his father's place by inheritance.

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[4] Reprinted from *North American Review* for June, 1889, in Carnegie, *The Gospel of Wealth* (Doubleday Doran Co., Garden City, N. Y., 1933) 1, 9–11.
[5] *Principles of the Civil Code,* Part II, Ch. III.
[6] *Principles of Political Economy,* Book V, Ch. II, Sec. 3.

Theorists have developed a number of other defenses of inheritance taxation. It has been suggested, for example, that the death tax is an appropriate toll charged by the state for use of the probate machinery and for other services in facilitating the transfer of private property at death. Others have argued that the state is collecting a belated fee for protecting the property during the decedent's lifetime or, more cynically, that it is levying a kind of penalty for any tax evasion that the decedent may have indulged in during life. Still others assert that inheritance comes as a windfall; therefore the tax imposes no sacrifice on the heirs, and they have an ability to pay that justifies the levy. One of the most influential of American authorities on public finance, E.R.A. Seligman, based his own support of the inheritance tax on arguments like these, rejecting the equalization of wealth theory as "very distinctly socialistic." [7] But it is hard to escape the conclusion that today's gift and estate taxes rest squarely on equalitarian foundations, to which these other theories are little more than decorative buttresses. Consequently one's attitude toward the tax is probably governed by the degree to which one wishes to see inequality of inheritance reduced. It is worth noting that for social and economic reasons some may favor equalization of *inherited* wealth without objecting to the same extent, if at all, to fortunes achieved by the personal effort of their owners.

Only an examination of the Treasury's files would disclose the extent to which estate and gift taxes have succeeded in their purpose of breaking up great family fortunes. Only since 1932 could important results have been achieved in this direction; before then, a net estate of $5 million, for example, would have been subjected to a federal tax of only about $500,000.[8] Between 1932 and 1950, as a result of several increases in rates, the tax on an estate of that size moved upward from a little more than $1 million to about $2 million.[9] The top tax bracket, reached by estates that exceed $10 million, has been 77 per cent since 1941. There have been recent examples of enormous estates that were really hard hit by death taxes. The $19.5 million estate of Robert W. Goelet was reduced to a net of less than $3 million by federal taxes of $11.5 million, state taxes of $4 million, and administration expenses of $1 million.[10] The estate of Mrs. Andrew Carnegie fared somewhat better, the federal and state tax bill being a little more than $11.5 million on an estate of $20.5 million of which $2.5 million was left to charity.[11] After the charitable legacies and taxes were paid, $6.5 million was left for the private beneficiaries.

The table on page 894, compiled from Treasury reports, presents a composite view of the federal tax liabilities reported by certain large estates during the years

[7] In 1943 the Soviet Union, which had reinstated the institution of inheritance after its initial abolition, repealed its heavy inheritance tax altogether. Gsovski, "Soviet Law of Inheritance: I," 45 *Mich. L. Rev.* 291, 299 (1945). Among American states, only Nevada shares this distinction. Nev. Const, Art. X, Sec. 1.

[8] The taxes paid in the early twenties by a group of large estates are reported in 37 *Trust Companies* 242 (1923); see Myers, *The Ending of Hereditary American Fortunes,* (J. Messner, Inc., 1939) 276–290, 302–303, 327–332, 343, 356, 361.

[9] State taxes (to the extent that they exceed the credit for state death taxes, see *infra* p. 1225) would impose an additional burden in most cases, but they would not ordinarily approach the federal tax in magnitude.

[10] *New York Times,* August 18, 1950, p. 7, col. 6.

[11] *Ibid.,* September 22, 1948, p. 36, col. 6.

1947–50. It will be noted that the effective federal estate tax rate averaged about 27 per cent on net estates of $1–2 million and 49 per cent on net estates of $5 million and over. Unfortunately, the state tax liability is not reported, so the total tax burden cannot be computed, but the credits taken for state death taxes [12] disclose that these state taxes were not less than the amounts set out in lines 8 and 9 of the table.

TAXATION OF CERTAIN LARGE ESTATES [13]

(Returns filed 1947–50)
In Millions of Dollars

	Gross Estates	
	$1–2 million	$5 million and up
1. Number of estates	1,199	110
2. Gross estate (aggregate)	$1,621	$1,188
3. Charitable deductions (aggregate)	$ 113	$ 195
4. Other deductions (aggregate)	$ 279	$ 152
5. Net estate before exemption (aggregate)	$1,228	$ 840
6. Total federal estate tax (aggregate)	$ 335	$ 409
7. Effective federal estate tax rate (line 6 divided by line 5)	27%	49%
8. State death taxes	$44 or more	$86 or more
9. Effective state death tax rate (line 8 divided by line 5)	4% or more	10% or more

It will be noted that charitable deductions are proportionately much larger for the estates of $5 million and up than for the estates of $1–2 million. For the very largest estates, the tax burden is often kept within manageable limits only by substantial bequests to non-profit family foundations or other institutions. The Edsel Ford estate paid nearly $25 million in federal estate taxes, but the figure would have been vastly larger if the Ford Foundation had not received all the decedent's nonvoting stock in the Ford Motor Company.[14] Henry Ford's estate,

[12] See §2011, *supra*, note 9.

[13] Compiled from Treasury Department, *Statistics of Income, 1946–49*. The information is taken from returns filed by citizens and resident aliens during the calendar years 1947–50, irrespective of date of death, and does not reflect corrections resulting from the Internal Revenue Service's audit of the returns. Because returns are reported by year of filing rather than by date of death, the table does not distinguish between estates that were able to use the "marital deduction" granted by the Revenue Act of 1948, *infra*, p. 1017, and those that could not. One other matter of importance is that the "net estate before exemption," upon which the tax rate is here computed, does not include several items of economic value to the heirs, namely, tax-exempt life insurance and property previously taxed within five years to another decedent. From the point of view of the heirs who receive either of these items, the effective tax rate is lower than the table indicates.

[14] *New York Times*, September 28, 1947, p. 24, col. 1.

variously estimated at $70,000,000 to $500,000,000[15] would also have gone primarily to the federal government had it not been for his huge bequest to the Ford Foundation. Of course, since the tax rate does not reach 100 per cent, such charitable transfers do not come entirely out the Treasury's share of the estate. Even in the largest estates, nearly 25 per cent of the charitable contribution is taken from the decedent's other beneficiaries. But a charitable transfer may enable the individual heirs to retain control of the family fortune, either when nonvoting stock is transferred to the foundation or, if the foundation is in friendly hands, even when voting stock is transferred to it.[16] On the other hand, if the entire estate had been left to the individual heirs, a sale to raise cash to meet the necessarily larger tax liability might have either created an unknown and potentially troublesome minority stockholding group[17] or terminated the family's control altogether. One need not deny the strength of the humanitarian impulse to suggest that charity is rewarded in these cases. Indeed, with stratospheric estates there may be no practicable alternative to becoming a benefactor of mankind.

In estimating the extent to which moneyed dynasties are dying out under today's tax structure, it must be remembered that *inter vivos* gifts may escape the estate tax altogether. The federal gift tax rate is only three-quarters of the estate tax rate, so a sizeable fortune may be transferred at a comparatively modest tax cost. A lifetime gift of $2.5 million, for example, would entail a gift tax liability of about $750,000 if made by a single person or about $635,000 if made by a married person. With large gifts, especially by persons of advanced age, there is always the possibility that the transfer will have to be treated as a gift "in contemplation of death," subject not merely to the lenient gift tax but to the estate tax as well. But the Revenue Act of 1950 has mitigated this peril by restricting the "contemplation-of-death" clause of the estate tax law to transfers occurring within three years of the donor's death. If this stimulates gifts by the rich, as it probably will, the effectiveness of the estate tax will be reduced *pro tanto*.

Moreover, in gauging the effectiveness of the estate and gift taxes it must be noted that they are no longer attuned primarily to the great hereditary fortunes that gave rise to the enactment of the federal estate tax in 1916. Even much more modest transfers have been brought within their ambit by subsequent changes in the law. Congress has become more sensitive to economic inequality; an estate of $100,000 is considered a fair target for a certain amount of social leveling,

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[15] *Ibid*, April 19, 1947, p. 1, col. 4, October 29, 1948, p. 22, col. 6.

[16] The House version of the Revenue Act of 1950 would have denied the charitable deduction when the contributor or his family had control of the foundation to which shares of a family corporation were transferred. The provision was eliminated by the Senate. See Senate Finance Committee, S. Rept. No. 2375, 81st Cong., 2d Sess., pp. 38–39.

[17] In the case of the Ford Motor Company, a successful suit by a minority stockholder led to Henry Ford's purchase in 1919 of all minority interests. See Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), James Couzens v. Commissioner, 11 B.T.A. 1040 (1928), Swards, *The Legend of Henry Ford* (1948) 64–74.

As this book goes to press (1955), it is reported in the press that the Ford Foundation may sell part of its holdings in the Ford Motor Company, and that the shares to be sold may carry restricted voting rights.

although there is no clear and present danger that inheritances of this amount will create a class of industrial lords and aristocratic idlers.

If estate and gift taxes have not yet fulfilled all the hopes of their supporters, they have also fallen short of confirming the fears of their opponents. Enthusiasm for making money may be dampened by knowledge that the government will ultimately be an uninvited heir; on the other hand, there is the tantalizing possibility that the business man now works harder to insure that his chosen heirs will receive a competence after taxes. Similarly, the possibility that business risks will be avoided and investment channeled into placid backwaters because of the tax may be countered by the possibility that greater risks will be undertaken because only thus can substantial sums be accumulated for the heirs. No conclusion as to the effects of estate and gift taxation on incentives can be more than a guess.

If we assume for the moment that the business man's pursuit of gain is neither slackened because the prize no longer attracts him, nor spurred on by a desire to win a greater prize, what is the consequence of a death tax? Adam Smith formulated a classic view of the incidence of death taxes: "Taxes upon the transference of property from the dead to the living fall finally as well as immediately upon the person to whom the property is transferred."[18] Notwithstanding a certain looseness of language, which at times leads us to speak of a tax "on" the deceased, it is obvious that it is the living heirs, not the decedent, who bear the brunt of an inheritance or estate tax. And the heir—unlike the unionized wage earner whose income tax has been increased—can do little or nothing to shift the burden of the tax along to others in order to recoup the portion of his legacy to which the government has helped itself. He cannot ask a higher price for his own goods or services, because he is in competition with others who, not having suffered as he, are not impelled to raise their prices. He may work more diligently, but though this would increase the amount of work done in the world, thus fulfilling one of the announced aims of death taxation, it would not shift the "incidence" of the tax to others.[19]

What of the decedent: Could he during his life have shifted the tax by anticipation, so to speak? If the tax was established immediately before his death, and he did not foresee its enactment, he could have done nothing to prevent the tax from falling, as Smith said, "finally as well as immediately" upon his heirs. But if he anticipated the tax at an earlier date, he might have adjusted to it in various ways. One adjustment is not really an example of shifting but of avoidance: He might have made lifetime gifts, taking advantage of the gift tax's exemptions and lower rates. Or, as suggested earlier, he might have worked harder to build up an estate, after taxes, equal to what he would have aimed for had there been no tax.

Could he, however, without additional work, have passed the anticipated tax

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[18] *Wealth of Nations*, Book V, Chapter 2, Part II, Appendix to Article I and II.

[19] This is not to say that the tax will have no effect on prices. By reducing the heir's demand for goods and services below the level which would have prevailed in the absence of a tax, it will tend to reduce the level of prices. The heir may be a beneficiary of this deflation, though of course it will be dispersed throughout the economy. It will also be counteracted to some extent if government spending increases because of the tax's yield.

along by increasing the price at which he sold his goods or services? A classical economist would say that higher prices are feasible only when the marginal costs of producing identical goods or services have gone up. Since by definition the marginal producer is making no profit, presumably he is not troubled about a future estate tax. Hence he will not regard the tax as a cost of doing business and will neither raise his prices nor be forced out of business by his failure to do so. Therefore, runs this analysis, the fortune-builder whose behavior we are examining cannot raise *his* prices without losing his customers to the marginal firm. Critics of this theory have pointed out that even a tax that is not a direct cost of production will have an impact on the producer's profit expectations. If the tax leads him to decide that the reward no longer justifies the risk, he may reduce the scale of his operations or leave the industry altogether. Such action in turn would affect the supply of goods and thus influence prices. Although the estate tax may exert pressure on the level of prices in this way, however, the fortune-builder himself will not have succeeded in shifting the tax in the sense of recouping it from others.

More modern economists agree with the classical view that the estate tax cannot be recovered through higher prices, but their reasoning does not proceed along the line of marginal-cost analysis described above. They reject the theory that prices are inflexibly geared to the marginal cost of production because they recognize that price inequalities may persist in an economy characterized by monopolistic rather than "pure" competition. Nevertheless, each producer charges whatever price he believes will yield him the largest return, in the light of the competition he must face and of the monopolistic advantages (trade names, location, prestige, and so on) he enjoys. A revision in his expectations about the rate of estate taxes can hardly alter his view of the optimum price for his product, although conceivably it would overcome his inertia and impel him to make a change that would have been advisable previously. Even under modern economic analysis, then, Smith's conclusion as to the incidence of a death tax seems correct.

The traditional objection to the inheritance tax has been that it destroys productive capital by transferring wealth from private hands to the government. As expounded by Adam Smith, the theory rested on the assumption that taxes on the transfer of property "increase the revenue of the sovereign, which seldom maintains any but unproductive labours, at the expense of the capital of the people, which maintains none but productive." [20] In urging in 1924 that the federal estate tax rates be reduced, Secretary of the Treasury Andrew Mellon said:

> Death taxes are taxes upon capital. It is obvious that, if the government, to maintain itself, were to take 50 per cent of every estate, small or large, and if on the average in the course of a generation a man could not double his inheritance, there would be an actual depletion of capital within the country and ultimately nothing would be left to tax. This is clear enough. . . .[21]

Others have echoed the same theme.

The theory cannot be accepted without important qualifications. First, as already indicated, we do not know what adjustments the decedent made in the

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[20] *Supra*, note 18.

[21] Mellon, "Economic Aspects of Estate and Inheritance Taxation," 39 *Trust Companies* 708, 709 (1924).

light of his expectations about the tax. Did he save more than he otherwise would have? If so, the transfer of part of his savings to the government does not reduce what would have been the aggregate of private savings in the absence of a tax. Second, one must compare the use to which the government puts the tax revenue with the use to which the heirs would have put the same funds. If they would have dined on guinea hen and champagne, the government's use of the tax revenue to build dams would serve to increase total national investment. If, on the other hand, they would have invested in new enterprises while the government increases the salary of its employees, total national investment is less for the tax.[22] Finally, if the estate finds it necessary to sell part of its assets (for example, shares of a family corporation) to pay the tax, the transfer will have an impact on total investment. This effect will depend upon the source from which the new owners of the securities draw the funds that make up the purchase price. If they curtail consumption to finance the purchase, the transfer of the securities will increase the investment of the new owners by as much as it decreases the investment of the estate, leaving total investment unchanged. If, on the other hand, the purchasers of the securities employ funds that otherwise would have gone into another investment, the tax has compelled the estate to reduce its investment without a corresponding increase in the investment of others. Then total private investment would tend to decline.

These three effects of the tax on total national investment (change in the original owner's savings, change in the government's expenditures, and change in the expenditures of those to whom the estate sells) need not be exerted in the same direction, and any conclusion about their net result would be precarious indeed. Consequently Secretary Mellon's simple prediction, which has enjoyed surprisingly wide acceptance, must be rejected.

Even if the estate tax could be shown, on balance, to discourage investment, it could not be condemned out of hand. For most contemporary economists recognize that the economy may be served better at one time by increasing total consumption and at another by increasing the volume of investment. And, as we have become painfully aware in recent years, there are times when expenditures for capital-destroying ends like armaments may serve the public (and even the heirs themselves) better than any other use of the funds.

It is sometimes asserted that a great fortune can no longer be accumulated, either because of high income tax rates or for other reasons, and that estate and gift taxation is therefore becoming an anachronistic survival of happier days. Although there is no statistical information, the premise is questionable. It is not likely, to be sure, that anyone could now accumulate a fortune that would be respectable by late nineteenth century standards if he had to rely upon salaries, dividends, or interest, since income of this nature may generate an effective income tax rate as high as 87 per cent. But the lower rate on long-term capital

[22] Of course, no government expenditure can be allocated to a specific tax collection, and even the total volume of expenditure is sometimes (for example, during a war) uninfluenced by the volume of revenue Consequently it might be argued that the extent of investment by the government is independent of the estate tax yield. Then the effect of the tax on investment would depend upon (1) whether the decedent had accumulated more during his lifetime in anticipation of the tax, and (2) whether, when investments are sold by the estate to pay the tax, the buyers curtail consumption in order to raise the purchase price.

gains—and, in a more specialized field, the boon of percentage depletion—still hold out hope to the ambitious. It was recently reported that a manufacturer of home permanent wave kits ("Which Twin Has the Toni?") had, at the age of 33, sold out a company in which he had invested $1000 four years earlier, for $20 million.[23] The tax on capital gains would take only 25 per cent of the profit. The Levitt family is said to have made more than $5 million on a single year's construction activities, of which at least a portion was capital gain rather than ordinary income.[24] A happy combination of capital gains and percentage depletion is reported to have created a new crop of millionaires in the previously unassuming state of Texas.[25] Moreover, unrealized appreciation in property is not reached by the income tax. Thus, stock or real estate will generate no income tax liability at all if held until death. A wise, or even a fortuitous, investment may be the seed that grows into a great fortune without any diminution by the Bureau of Internal Revenue. Although one cannot know how many persons have become millionaires in recent years, it seems likely that, as long as the income tax laws continue to leave the door open to substantial accumulations, the estate and gift taxes will have a task to perform.

The federal government imposes an *estate* tax, while most of the states impose *inheritance* taxes. The traditional differentiation between them is that an estate tax is levied on the privilege of transmitting property at death, while an inheritance tax is on the privilege of receiving property from the dead. Terminology aside, the distinction is between a tax graduated according to the size of the decedent's entire estate and one that is graduated for each beneficiary according to the size of his share and his relationship to the decedent.

Theoretically an estate tax is simpler to administer than an inheritance tax, because it is not necessary to place a value on each beneficiary's portion, a task of some complexity when future interests are involved. Yet the federal estate tax does not escape this problem altogether. A deduction has always been allowed for charitable bequests, and in 1948 a "marital deduction" was inaugurated for property passing to a surviving spouse. Both deductions introduce inheritance tax characteristics into the estate tax structure. Moreover, it is becoming ever more common to provide (either by will or by statute) that the federal tax shall be apportioned among the various property interests that constitute the estate, instead of falling, as do other debts and charges, on the residuary alone. Although such an apportionment is not binding on the Treasury, which can collect the tax from any part of the estate, the executor must value each beneficiary's share in order to apportion the tax in accordance with the testamentary or statutory scheme.

Since the inheritance tax is graduated according to the heir's relationship to the decedent, it could be employed to penalize close family control of the decedent's fortune. This is a function that the estate tax, ordinarily taking no account of the beneficiary's identity, could not perform. In point of fact, however, the inheritance tax rate schedules place a premium on transfers to direct descendents,

[23] *Life*, April 4, 1949, p 72, 84.
[24] *Time*, July 3, 1950, p. 72.
[25] "The Land of the Big Rich," *Fortune*, April, 1948, p. 98.

the purpose of breaking up family accumulations being overbalanced in this instance by an ethical view that direct descendents have a birthright claim to the wealth while legacies to collateral relatives and "strangers" are in the nature of windfalls. Thus, in Massachusetts, the tax on "Class A beneficiaries" (spouses, parents, children, and grandchildren) ranges from 1 per cent on the first $10,000 received to 9 per cent on the excess over $1 million. The rates on "Class B beneficiaries" (lineal ancestors other than parents, lineal descendents other than children and grandchildren, daughters-in-law, and sons-in-law) range from 2 per cent to 11 per cent; on "Class C beneficiaries" (brothers and sisters, nephews and nieces, step-children, and step-parents), from 4 per cent to 15 per cent; on "Class D beneficiaries" (all others), from 6 per cent to 15 per cent. The classifications and rates vary among the 37 states that impose inheritance taxes, but the broad outline is the same. close rather than distant beneficiaries are favored by the inheritance tax rates. Indeed, in the first state inheritance tax (1826), Pennsylvania exempted direct heirs altogether, setting a pattern that was not broken until the last decade of the nineteenth century.

In another respect, however, a graduated inheritance tax encourages the dispersion of wealth more than the estate tax. Being graduated separately for each beneficiary's share, such an inheritance tax penalizes less heavily the fortune that is divided among two or more beneficiaries (of a given statutory class) than one that goes to a single member of that class. To take Massachusetts as an example again, if an estate of $300,000 were left to one child, the tax would be $13,650, while if the same estate were divided among three children, the tax on each share would be $3,150, and the total tax $9,450. Although a tax difference of this size is hardly a barrier to concentration, the inheritance tax contains a seed that might be nurtured into effective life. The estate tax on the other hand, does not discriminate among recipients of the decedent's bounty (except for the charitable and marital deductions) and, since the rate fluctuates only with the size of the *entire* estate, it does not place a heavier burden on an estate that is transferred to a single beneficiary than on one that is split up among a number.

Neither an estate nor an inheritance tax could be very effective if it reached only property owned by the decedent on the date of his death. Indeed, the larger the fortune, the more feasible it would ordinarily be to avoid a death tax by *inter vivos* gifts. The problem was recognized and met in Pennsylvania's 1826 statute, mentioned earlier, which reached out to bring into the taxable estate any property whose transfer was "intended to take effect, in possession or enjoyment after the death" of the transferor. It has since become standard operating procedure to include this clause in death tax statutes, its exegesis is the subject of extended study in this book. In 1891, the New York inheritance tax law introduced another now famous clause, which subjected to the death tax any property that the decedent had transferred during his lifetime "in contemplation of death." These clauses, and other provisions with a similar aim, have extended the web of both the estate and the inheritance tax to catch much peripheral property, as well as that which the decedent owned outright at the time of death.

Property may still be transferred during one's life, and thereby escape death tax, if the transferor retains no strings and is not acting "in contemplation of death." Estate and inheritance taxes are to that extent ineffectual as revenue

measures and, more important, as instruments for reducing inequality of wealth. Indeed, one commentator has observed.

> Until recently, the whole system of levies in the United States could be regarded mainly as a penalty on those whose benefactors failed to pass down their property before death. That any revenues were forthcoming is presumably attributable to untimely deaths, to utter distrust of beneficiaries, or to mere disregard of their interests.[26]

To block this route by which assets may be transmitted from one generation to another without payment of estate or inheritance tax, the federal government and 12 states have enacted a gift tax. As will be learned more fully later, an *inter vivos* transfer may still be cheaper than a transfer at death, because of the gift tax's lower rates, generous exemptions, and separate scale of progression, although there are also counterbalancing tax advantages in postponing the transfer of one's property until death. If a transfer during life is subjected to a gift tax and ultimately is determined to be subject to estate tax as well (because, for example, it was made "in contemplation of death"), the estate may be permitted to credit the gift tax as a "down payment" on the estate tax liability.[27] Needless to say, the line separating transfers subject only to gift tax from those that engender estate tax liability as well is often established only by litigation

The difficulty of drawing this line of demarcation and, even more, grave doubt whether it should exist at all have led to proposals for merging the two existing levies into an "integrated transfer tax." Such a tax would impose—as today's federal gift and estate taxes do not—about the same total tax burden on an estate transferred piecemeal over the years as on one that is held intact until death. The existing dual structure may foster an earlier division of wealth, presumably a socially desirable trend, but the extent to which it does so is problematical. The volume of gifts reported to the Treasury is surprisingly meager.[28] An integrated transfer tax would have advantages that might outweigh any favorable aspects of the present discrimination in favor of lifetime gifts.

Integration has another aspect. What is (or should be) the relationship between gift and death taxes, on the one hand, and the income tax, on the other? As the law now stands, a transfer of property from father to son may be complete enough so that a gift tax must be paid by the father, yet the yield from the transferred property may still be taxed as his income. Contrariwise, a transfer may be insufficiently final to require payment of gift tax, yet complete enough to terminate the father's income tax liability. Similarly, a transfer may shift the income tax liability although the property will be subject to the estate tax as part of the transferor's estate, and vice versa. Judge Jerome N. Frank has suggested that the concept of a transfer is so different from one taxing statute to another that different verbal symbols might be used "to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income

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[26] Simons, *Personal Income Taxation* (University of Chicago Press, Chicago, Ill., 1938), 131.

[27] The credit may be for only a part of the gift tax paid, rather than its full amount. *Infra*, pp. 1230–1.

[28] See Pechman, "Analysis of Matched Estate and Gift Tax Returns," 3 *Nat. Tax J* 153 (1950); Butters, Thompson, and Bollinger, *Effects of Taxation: Investments by Individuals*, Chapter XV (1953).

tax law, and a 'geft' in the estate tax law." [29] The statutory anomalies spring from minor differences in phraseology rather than from rational policy, and a recent proposal for integrating the estate and gift taxes provides for "correlating" the substituted transfer tax with the income tax.[30] The aim is to tax the income from the property to its original owner until he relinquishes enough control to warrant payment of the transfer tax, but to relieve him of income tax liability thereafter.

Another anomaly in the relation between the gift and estate taxes and the income tax is the transferee's "basis" for property received by gift or inheritance. Suppose the value of stock purchased by the original owner for $100 per share has appreciated to $200 at the time the shares are transferred by gift or inheritance. If the recipient later sells the stock for $250 per share, will his gain be $50 or $150? If the transfer was by gift, Section 1015(a) of the Internal Revenue Code requires the donee to use his donor's cost "basis" of $100, so that the gain on the sale is $150 per share. But if the stock was received by inheritance, the beneficiary's "basis," prescribed by Section 1014(a) of the Internal Revenue Code, is the fair market value at the time of his transferor's death, or $200, so that the gain on the sale is only $50 per share. Thus appreciation in donated property will be charged against the donee, but appreciation in property held until death goes entirely untaxed. The discrimination works against the tax advantages, mentioned above, that *inter vivos* gifts ordinarily enjoy over transfers at death. Moreover, the "stepped-up" basis that attaches to appreciated property transmitted at death undoubtedly reduces the liquidity of such assets when held by persons of advanced age.

More basic in the relationship between the transfer taxes and the income tax is the fact that property received by gift or inheritance is not treated as income to the transferee upon receipt. The exemption of gratuitous receipts (assuming it not to be compelled by the Constitution)[31] has been defended on various grounds, principally because the transfer itself is subject to gift or inheritance tax, but also because the progressive nature of the income tax would levy a heavy toll on any property that was transferred in a single year rather than over a period of time. Neither objection inheres in the nature of things. The gift and estate taxes could be modified or abolished if it were better tax policy to treat gratuitous receipts as taxable income; and an "averaging" device could be devised to remedy the unfair "bunching" of income in a single year.[32] But abolition of the existing exemptions has never been seriously considered by Congress, despite vigorous

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[29] Commissioner v. Estate of Beck, 129 F 2d 243, 246 (2d Cir. 1942).

[30] *Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax* (1947), prepared jointly by an Advisory Committee to the Treasury Department and by the Office of Tax Legislative Counsel.

[31] Since these receipts have enjoyed a statutory exemption since the prototype of today's federal individual income tax was enacted in 1913, there has been no occasion for a judicial determination whether they constitute income within the meaning of the Sixteenth Amendment. But they were treated as income by the Revenue Act of 1894, the invalidation of which by Pollock v. Farmers' Loan & Trust Co, *supra*, p. 3, led to the adoption of the Sixteenth Amendment.

[32] *Supra*, pp. 693–724.

advocacy of such action by at least one distinguished tax economist, the late Professor Henry Simons.[33]

Somewhat more interest has been displayed in another proposal relating to gratuitous receipts, although it too is still far from Congressional action. This is the "accessions" tax, a scheme to replace the existing estate and gift taxes by a single tax imposed on the recipient of property by gift or inheritance.[34] The tax would be cumulative throughout the recipient's life, taxing each "accession" to his unearned wealth more heavily than the previous increment. No distinction would be made between gifts and inheritance or between property received from one benefactor and property received from several. The novel feature of the proposed tax is that it would focus attention on the recipient of wealth rather than on the transferor, treating all gratuitously acquired wealth as a unit. Thus, a taxpayer who received a total of $1 million partly by gift and partly by inheritance from various benefactors over a period of time would incur the same tax liability as one who received the same amount at one time from a single transferor. The accessions tax might be likened to an income tax levied only on gratuitous receipts, but with the lowest tax bracket each year starting where the highest bracket of the previous year ended. The "accessions" tax is an effort to achieve more completely the social aim of the gift and death taxes, not only by taxing more heavily a fortune that is transmitted intact than one that is split up, but also by taxing more heavily the transferee who already has received property from other transferors. The estate tax does neither, while the gift and inheritance taxes do only the first.

Other proposals for reforming the structure of transfer taxation are aimed at the fact that under existing law, the size of the tax on the transmission of a family fortune depends upon the number of transfers that occur, rather than on the number of generations separating the transferor from the transferee. Thus, if *A* gives property to *B*, his son, and *B* (after enjoying the income for a time) gives the same property to *C*, his son, two gift taxes must be paid. Only one would be due if the property were transferred directly by *A* to *C*. Similarly, if there were two transfers by will, both *A*'s estate and *B*'s would be subjected to estate tax;[35] but only one estate tax would be due if *A*'s will had granted a life interest to *B* and the remainder upon *B*'s death to *C*. And if *A* had been so unwise as to leave the property to his wife, who later transferred it to *B*, there would be still another tax (and yet another if *B* in turn had transmitted it to *his* wife), though some alleviation for interspousal transfers is afforded by the "marital deduction" introduced by the Revenue Act of 1948. That deduction aside, the total tax burden on a given family fortune is governed by the number of hands—rather than the number of generations—through which the property passes. In some cases the number of transfers is determined by accidents of birth and longevity,

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[33] Simons, *Personal Income Taxation* (1938) 125–147; see also his *Federal Tax Reform* (1950) 136–139; *cf.* Vickrey, *Agenda for Progressive Taxation* (1947) 198–202.

[34] Rudick, "A Proposal for an Accessions Tax," 1 *Tax L. Rev.* 25 (1945), Rudick, "What Alternative to the Estate and Gift Taxes?" 38 *Calif. L. Rev.* 150 (1950).

[35] If, however, *B*'s death occurred within ten years of *A*'s, *B*'s estate would be entitled to take a credit for part or all of the tax paid by *A*'s estate, under the previously taxed property provision, §2013. See *infra*, p. 1231.

resulting in unequal tax burdens upon taxpayers whose economic circumstances may be comparable. In others, the number of transfers and therefore the total tax burden are determined by ingenuity in the use of life estates and other devices that may introduce undesirable rigidities into family settlements and that in any event are more feasible for the really rich than for others.

Several schemes have been devised to insure that the same burden will be imposed on the transfer of a given sum from one generation to another regardless of the number of steps in which this is accomplished. One of the most ingenious, although its complexity is forbidding, is the "bequeathing power succession tax" proposed by Professor William Vickrey.[36] His mechanism for making the tax independent of the number of transfers is to graduate it according to the difference in age between the transferor and transferee, so that the greater the gap the greater will be the tax. Two other remedies for the same evil, which depart much less radically from the present tax structure, are (1) to levy the existing estate tax on the life beneficiary (*B* in the example above) at the time of his death by including the property of which he is the life tenant in his estate, or (2) to levy a new auxiliary tax on the life tenant, based solely upon property of which he has enjoyed the income.[37]

This catalogue of possible reforms should not be closed without mention of the Rignano plan for increasing the rate of the inheritance tax with the number of transfers intervening between the present owner and the original creator of the wealth.[38] Thus *Z*'s property on his death would be segregated according to its origin and taxed accordingly· one tax rate on that part which Z had himself earned or saved; another and higher rate on that part inherited from *X* which *X* had himself earned or saved, a still higher rate on that part inherited from *X* which *X* in turn had inherited from its creator *Y*; and so on. By imposing a confiscatory rate after several transfers, Rignano's plan would permit a family fortune to continue only if each generation or two through its own efforts made substantial additions to the accumulation.

No doubt the reader has found this kaleidoscope of proposed reforms bewildering. Encountering them without a familiarity with the existing law, he may also have found the significance of some proposals a bit obscure. But even a casual acquaintance with possible improvements may help to illuminate his study of today's statutes, and alternatives should not be regarded as mere afterthoughts, but instead should be evaluated at many points in the study of what follows. Moreover, there is no law against turning backward in a book when the spirit moves.

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[36] Vickrey, *Agenda for Progressive Taxation* (1947) 224–248.

[37] See Surrey, "An Introduction to Revision of the Federal Estate and Gift Taxes," 38 *Calif. L. Rev.* 1, 18–23 (1950); Mills, "Transfers from Life Tenant to Remainderman in Relation to the Federal Estate Tax," 19 *Taxes* 195 (1941), *infra*, pp. 981–3.

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Statistics. Statistical information on the federal gift and estate taxes may be found in the Treasury Department's annual *Statistics of Income*, Part I, the latest number of which is for the year 1950. More recent but less detailed statistics are contained in the *Annual Report* of the Commissioner of Internal Revenue. State tax collections are reported annually in *State Finances*, published by the Bureau of the Census. So far as the extent of concentrated wealth is concerned, our knowledge is meager. The systematic studies are fragmentary. Temporary National Economic Committee, Monographs No. 4 ("Concentration and Composition of Individual Incomes, 1918–1937") and No. 29 ("The Distribution of Ownership in the 200 Largest Nonfinancial Corporations"); Powell and Looker, "Decedents' Estates," 30 *Col. L. Rev.* 919 (1930), Crum, *The Distribution of Wealth* (Harvard Business School Research Studies No. 31) (1935); Doane, *The Anatomy of American Wealth* (1940), Ward and Beuscher, "The Inheritance Process in Wisconsin," [1950] *Wis. L. Rev.* 393, 399; Butters, Thompson, and Bollinger, *Effects of Taxation: Investments by Individuals* (1953); Harriss, "Wealth Estimates as Affected by Audit of Estate Tax Returns," 2 *Nat. Tax J.* 316 (1949). The best-known popular works, which are both unsystematic and fragmentary, are: Myers, *History of the Great American Fortunes* (Modern Library ed., 1936) and his *The Ending of Hereditary American Fortunes* (1939).

Theory and Philosophy. An excellent brief account of the theory of inheritance taxation is Shultz's article, "Inheritance Taxation," in the *Encyclopedia of the Social Sciences.* In addition to the works cited in the previous paragraph, consult Seligman, "The Inheritance Tax" in his *Essays in Taxation* (9th ed., 1921), an influential essay by a pioneer authority on American public finance; Wedgewood, *The Economics of Inheritance* (Pelican ed., 1939) 199–216; Dalton, *The Inequality of Incomes* (1920) 281–345; and Rignano, *The Social Significance of the Inheritance Tax* (1924).

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CHAPTER 10

FEDERAL GIFT TAXATION: INTRODUCTORY

Section A. History and Constitutionality

The materials in this chapter are no more than an introduction to the federal gift tax, sketching as they do only an outline of the tax's coverage. The details have been postponed until later chapters, in order to compare the competing claims of the gift tax and the estate tax in specific situations.

PAUL
FEDERAL ESTATE AND GIFT TAXATION

Boston· Little, Brown and Company, 1942 and 1946 Supp., Secs. 15.01–.02.
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§*15.01. Introductory.* The gift tax, first introduced into our revenue system in 1924, then abandoned for a number of costly years, and then reintroduced in 1932, has become an integral part of that system. Except for its administrative provisions, which are patterned after the corresponding provisions relating to the income and estate taxes, the statute is short and deceptively simple. Congress has followed the policy of broad generalization in the drafting of the statute, thus leaving much to the administrative and judicial processes of interpretation. These processes are faltering and slow; much trial and error must be involved in dealing with the adaptation of general principles and concepts of a new form of taxation to the manifold complexities of the daily life of thousands of taxpayers, many of whom are ready to employ every available device to avoid the impact of the tax. The result is that in terms of development the gift tax is in a more fluid condition than the older and longer tried income and estate taxes. Conclusions as to any aspect of the gift tax law must be more tentative than conclusions in the field of income and estate taxation. And, as we have gathered from earlier chapters in these volumes, the income and estate taxes are hardly in a completely settled condition.

One complicating factor in connection with the gift tax is its relationship to the income and estate taxes. The outlines of that relationship are a vague realm, but that some relationship exists is clear enough. The result is a necessity of dealing with statutes, regulations, and decisions in these other fields. And as these other taxes develop, so must the gift tax change and accommodate itself. . . .

§*15.02. The History of the Statute and the Regulations.* The present gift tax had a forerunner in the 1924 Act, which was passed as "the outcome of a minor

skirmish" in the course of a struggle over income surtax rates. Even in 1924 gifts and transfers in trust had developed as an effective means of avoiding not only *estate* taxes, but also *income* taxes; in the instance of the latter tax gifts and trusts served to distribute income among a greater number of taxpayers and thus to reduce the surtax brackets. Over the opposition of the Treasury and the Republican majority a group of progressive Republicans and Democrats obtained the enactment of the 1924 Act to counteract this type of income tax avoidance. The 1924 tax lasted only until the next revenue act, which, as a result of a general rate reduction and an astonishingly shortsighted notion of the undue expense of gift tax administration, repealed the tax for years beginning with 1926. Six years later, when revenue exigencies became aggravated, Congress again enacted a better gift tax; an increasing demand for revenue has induced Congress to lift these rates in 1934, in 1935, and again in 1941. The first Revenue Act of 1940 added a defense tax to the gift tax consisting of 10 per cent of the gift tax; the defense tax has been integrated into the gift tax rates by the 1941 Act and no longer exists as a separate levy. Moreover, the 1935 Act reduced the specific exemption from $50,000 to $40,000. The 1938 Act reduced from $5,000 to $4,000 the amount of tax-free gifts which may be made to any single donee. The 1942 Act has reduced the specific exemption to $30,000 and the annual exclusion to $3,000.

BROMLEY v. McCAUGHN

Supreme Court of the United States, 1929
280 U.S. 124

Mr. Justice Stone delivered the opinion of the Court.

In this case, pending in the Court of Appeals for the Third Circuit, that court has certified to this questions of law concerning which it asks instructions for the proper disposition of the cause. Judicial Code, §239, as amended by Act of February 13, 1925.

Bromley, a resident of the United States, brought the present suit in the District Court for Eastern Pennsylvania, to recover a tax alleged to have been illegally exacted, upon gifts made by him after the effective date of §319 of the Revenue Act of 1924 (43 Stat. 253, 313, as amended by §324(a) of the Revenue Act of 1926, 44 Stat. 9, 86). This section imposes a graduated tax "upon the transfer by a resident by gift" during the calendar year "of any property wherever situated. . . ." In computing the amount of the gift subject to the tax, §321, in the case of a resident, exempts gifts aggregating $50,000, gifts to any one person which do not exceed $500, and certain gifts for religious, charitable, educational, scientific and like purposes. The questions certified are:

1. Are the provisions of Sections 319–324 of the Revenue Act of 1924, as amended by Section 324 of the Revenue Act of 1926, when applied to transfers of property by gift *inter vivos*, made after the effective dates of the cited Revenue Acts and not made in contemplation of death, invalid, because they violate (a) the third clause of Section 2 and (b) the fourth clause of Section 9 of Article 1 of the Constitution in that the tax they impose is a direct tax and has not been apportioned?

2. Are the cited provisions, when applied to transfers of property made in like circumstances, invalid because they violate (a) the Fifth Amendment of the Constitution and (b) the first clause of Section 8 of Article 1 of the Constitution in that they impose a tax which is graduated and subject to exemptions and therefore lacks uniformity, and also deprive a person of his property without due process of law?

1. The first question was mooted by counsel, but not decided, in *Blodgett* v. *Holden*, 275 U.S. 142, and *Untermeyer* v. *Anderson*, 276 U.S. 440. The general power to "lay and collect taxes, duties, imposts and excises" conferred by Article I, §8 of the Constitution, and required by that section to be uniform throughout the United States, is limited by §2 of the same article, which requires "direct" taxes to be apportioned, and §9, which provides that "no capitation or other direct tax shall be laid unless in proportion to the census" directed by the Constitution to be taken. As the present tax is not apportioned, it is forbidden if direct.

The meaning of the phrase "direct taxes" and the historical background of the Constitutional requirement for their apportionment have been so often and exhaustively considered by this Court, *Hylton* v. *United States*, 3 Dall. 171; *Pollock* v. *Farmers Loan & Trust Company*, 157 U.S. 429, 158 U.S. 601; *Knowlton* v. *Moore*, 178 U.S. 41; *Nicol* v. *Ames*, 173 U.S. 509, 515, that no useful purpose would be served by renewing the discussion here.* Whatever may be the precise line which sets off direct taxes from others, we need not now determine. While taxes levied upon or collected from persons because of their general ownership of property may be taken to be direct, *Pollock* v. *Farmers Loan & Trust Company*, 157 U.S. 429, 158 U.S. 601, this Court has consistently held, almost from the foundation of the government, that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned, and it is enough for present purposes that this tax is of the latter class. . . .

It is a tax laid only upon the exercise of a single one of those powers incident to ownership, the power to give the property owned to another. Under this statute all the other rights and powers which collectively constitute property or ownership may be fully enjoyed free of the tax. So far as the constitutional power to tax is concerned, it would be difficult to state any intelligible distinction, founded either in reason or upon practical considerations of weight, between a tax upon the exercise of the power to give property *inter vivos* and the disposition of it by legacy, upheld in *Knowlton* v. *Moore*, *supra*, the succession tax in *Scholey* v. *Rew*, 23 Wall 331, the tax upon the manufacture and sale of colored oleomargarine in *McCray* v. *United States*, 195 U.S. 27, the tax upon sales of grain upon an exchange in *Nicol* v. *Ames*, *supra*, the tax upon sales of shares of stock in *Thomas* v. *United States*, 192 U.S. 363, the tax upon the foreign built yachts in *Billings* v. *United States*, 232 U.S. 261, the tax upon the use of carriages in *Hylton* v. *United States*, *supra;* compare *Veazie Bank* v. *Fenno*, 8 Wall. 533, 545, *Thomas* v. *United States*, *supra*, 370.

It is true that in each of these cases the tax was imposed upon the exercise of one

* *Supra*, pp. 3–6. [Ed.]

of the numerous rights of property, but each is clearly distinguishable from a tax which falls upon the owner merely because he is owner, regardless of the use or disposition made of his property. See *Billings* v. *United States, supra; cf. Pierce* v. *United States,* 232 U.S. 290. The persistence of this distinction and the justification for it rest upon the historic fact that taxes of this type were not understood to be direct taxes when the Constitution was adopted and, as well, upon the reluctance of this Court to enlarge by construction, limitations upon the sovereign power of taxation by Art. I, §8, so vital to the maintenance of the National Government. *Nicol* v. *Ames, supra,* 514, 515.

It is said that since property is the sum of all the rights and powers incident to ownership, if an unapportioned tax on the exercise of any of them is upheld, the distinction between direct and other classes of taxes may be wiped out, since the property itself may likewise be taxed by resort to the expedient of levying numerous taxes upon its uses; that one of the uses of property is to keep it, and that a tax upon the possesion or keeping of property is no different from a tax on the property itself. Even if we assume that a tax levied upon all the uses to which property may be put, or upon the exercise of a single power indispensable to the enjoyment of all others over it, would be in effect a tax upon the property, see *Dawson* v. *Kentucky Distilleries & Warehouse Co.,* 255 U.S. 288, and hence a direct tax requiring apportionment, that is not the case before us.

The power to give cannot be said to be a more important incident of property than the power to use, the exercise of which was taxed in *Billings* v. *United States,* and even though differences in degree may be carried to a point where they produce distinctions in kind, the present levy falls so far short of taxing generally the uses of property that it cannot be likened to the taxes on property itself which have been recognized as direct. It falls, rather, into that category of imposts or excises which, since they apply only to a limited exercise of property rights, have been deemed to be indirect and so valid although not apportioned.

2. The uniformity of taxation throughout the United States enjoined by Art I, §8, is geographic, not intrinsic. A graduated tax, on legacies, granting exemptions, *Knowlton* v. *Moore, supra,* or on incomes, *Brushaber* v. *Union Pacific R. Co.,* 240 U.S. 1, does not violate this clause of the Constitution, nor are such taxes infringements on the Fifth Amendment. *Knowlton* v. *Moore, supra,* page 109; *Brushaber* v. *Union Pac. R. Co., supra,* pages 24, 25. Graduated taxes on inheritances or successions, with provisions for exemptions, have so often been upheld as not violating either the due process or the equal protection clauses of the Fourteenth Amendment, *Stebbins* v. *Riley,* 268 U.S. 137, as to leave little ground for supposing that taxation by Congress embracing these features, and otherwise valid, could be deemed a denial of the due process clause of the Fifth. See *Van Oster* v. *Kansas,* 272 U.S. 465, 468.

It is suggested that the schemes of graduation and exemption in the present statute, by which the tax levied upon donors of the same total amounts may be affected by the size of the gifts to individual donees, are so arbitrary and unreasonable as to deprive the taxpayer of property without due process. But similar features of state death taxes have been held not to infringe the Fourteenth Amendment since they bear such a relation to the subject of the tax as not "to preclude the assumption that the legislature, in enacting the statute, did not act arbitrarily or without the exercise of judgment and discretion which rightfully

belong to it." *Stebbins* v. *Riley*, *supra*, p. 145. No more can they be a basis for holding that the graduation and exemption features of the present statute violate the Fifth Amendment.

The answer to both questions is, No.

Opinion of MR. JUSTICE SUTHERLAND, dissenting, delivered by MR. JUSTICE BUTLER.

In the convention which framed the Constitution, Mr. King on one occasion asked what was the precise meaning of "direct taxation," and Mr. Madison informs us that no one answered. That Mr. Madison took the pains to record the incident indicates that it challenged attention but that no one was able to formulate a definition. And though we understand generally what is a direct tax and what taxes have been declared to be direct, we are still as incapable of formulating an exact definition as were those who wrote the taxation clauses into the Constitution. Since the *Pollock* case, however, we know that a tax on property, whether real or personal, or upon the income derived therefrom, is direct; and that to levy a tax by reason of ownership of property is to tax the property. *Dawson* v. *Kentucky Distilleries Co.*, 255 U.S. 288, 294.

The right to give away one's property is as fundamental as the right to sell it or, indeed, to possess it. To give away property is not to exercise a separate element or incident of ownership, like the use of a carriage, but completely to sever the donor's relation to the property and leave in him no element or incident of ownership whatsoever. Reasonably it cannot be doubted that the power to dispose of property according to the will of the owner is a property right. If a tax upon the sale of property, irrespective of special circumstances, is a direct tax, it is clear that a tax upon the gift of property, irrespective of special circumstances, is, likewise, direct. In my opinion, both are direct because they are in substance and effect not excise taxes but taxes upon property. By repeated decisions of this Court it has become axiomatic that it is the substance and not the form that controls in such matters.

Brown v. *Maryland*, 12 Wheat. 419, involved the validity of a state statute which exacted a license fee of $50 of importers of foreign goods and other persons selling the same by wholesale, bale or package, etc. The act was held void as imposing a duty on imports. It was argued that the tax was not upon the article but upon the person, that the state had the power to tax occupations, and this was nothing more. To this Chief Justice Marshall replied (p. 444) in words that have been repeatedly approved in subsequent decisions of this Court:

> It is impossible to conceal from ourselves, that this is varying the form, without varying the substance It is treating a prohibition, which is general, as if it were confined to a particular mode of doing the forbidden thing. All must perceive, that a tax on the sale of an article, imported only for sale, is a tax on the article itself.

In *Cook* v. *Pennsylvania*, 97 U.S. 566, it was held that a tax on the amount of sales made by an auctioneer was a tax upon the goods sold, and where these goods were imported in the original package and sold for the importer the law authorizing the tax was void.

Nicol v. *Ames*, 173 U.S. 509, is not to the contrary of these cases, but in complete accord with them. There it was held that a tax levied upon a sale of property effected at a board of trade or exchange was an excise laid upon the

privilege, opportunity or facility afforded by boards of trade or exchanges for the transaction of the business and not upon the property *or the sale thereof*, which, it was conceded, would be a direct tax and void without apportionment. Brief quotations from the opinion will make the distinction clear. Referring to the cases which had been cited against the tax, including *Brown* v. *Maryland*, *supra*, and the *Pollock* case, it was said that all these cases involved the question whether the taxes assailed were in effect taxes upon property and (p. 519): "If this tax is not on the property *or on the sale thereof*, then these cases do not apply." At p 520, answering the contention that the tax was one on the property sold, it was said: "It is not laid upon the property at all, nor upon the profits of the sale thereof, nor upon the sale itself considered separate and apart from the place and the circumstances of the sale." And finally at p. 521, the Court said in words that admit of no mistake "A tax upon the privilege of selling property at the exchange and of thus using the facilities there offered in accomplishing the sale differs radically from a tax upon every sale made in any place. *The latter tax is really and practically upon property*. It takes no notice of any kind of privilege or facility, and the fact of a sale is alone regarded."

To me it seems plain that a tax imposed upon an ordinary gift, to be measured by the value of the property given and without regard to any qualifying circumstances, is a tax by indirection upon the property, as much for example, as a tax upon the mere possession by the owner of a farm, measured by the value of the land possessed, would be a tax on the land. To call either of them an excise is to sacrifice substance to a mere form of words. I think, therefore, the first question certified, without stopping to consider the second, should be answered in the affirmative.

MR. JUSTICE VAN DEVANTER and MR. JUSTICE BUTLER concur in this opinion.

Section B. The Meaning of "Transfer by Gift"

Internal Revenue Code of 1954

Sec. 2501. Imposition of Tax.

(a) General Rule.—For the calendar year 1955 and each calendar year thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar year by any individual, resident or nonresident, except transfers of intangible property by a nonresident who is not a citizen of the United States and who was not engaged in business in the United States during such calendar year.

Sec 2511. Transfers in General.

(a) Scope.—Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

Sec. 2512. Valuation of Gifts.

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

REPORT OF HOUSE COMMITTEE ON WAYS AND MEANS, 72D CONG., 1ST SESS.

H. Rept. No. 708, 1932, reprinted in 1939-1 C.B. (Part 2) 476–478

The terms "property," "transfer," "gift," and "indirectly" are used [in the gift tax law] in the broadest and most comprehensive sense; the term "property" reaching every species of right or interest protected by law and having an exchangeable value.

The words "transfer . . . by gift," and "whether . . . direct or indirect" are designed to cover and comprehend all transactions (subject to certain express conditions and limitations) whereby, and to the extent . . . that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment. . . .

Since the tax is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth, it is provided in this section [§2512(b), 1954 Code] that where the transfer is made for less than an adequate and full consideration in money or money's worth, the excess in value of the property transferred over such consideration shall be deemed a gift.

BURNET v. GUGGENHEIM

Supreme Court of the United States, 1933
288 U.S. 280

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be decided is whether deeds of trust made in 1917, with a reservation to the grantor of a power of revocation, became taxable as gifts under the Revenue Act of 1924 when in 1925 there was a change of the deeds by the cancellation of the power.

On June 28, 1917, the respondent, a resident of New York, executed in New Jersey two deeds of trust, one for the benefit of his son, and one for the benefit of his daughter. The trusts were to continue for ten years, during which period part of the income was to be paid to the beneficiary and part accumulated. At the end of the ten year period the principal and the accumulated income were to go to the beneficiary, if living; if not living, then to his or her children; and if no children survived, then to the settlor in the case of the son's trust, and in the case of the daughter's trust to the trustees of the son's trust as an increment to the fund. The settlor reserved to himself broad powers of control in respect of the trust property and its investment and administration. In particular, there was an unrestricted power to modify, alter or revoke the trusts except as to income, received or accrued. The power of investment and administration was

transferred by the settlor from himself to others in May, 1921. The power to modify, alter or revoke was eliminated from the deeds, and thereby canceled and surrendered, in July, 1925.

In the meanwhile Congress had passed the Revenue Act of 1924 which included among its provisions a tax upon gifts. "For the calendar year 1924 and each calendar year thereafter . . . a tax . . . is hereby imposed upon the transfer by a resident by gift during such calendar year of any property wherever situated, whether made directly or indirectly," the tax to be assessed in accordance with a schedule of percentages upon the value of the property.

At the date of the cancellation of the power of revocation, the value of the securities constituting the corpus of the two trusts was nearly $13,000,000. Upon this value the Commissioner assessed against the donor a tax of $2,465,681, which the Board of Tax Appeals confirmed with a slight modification due to a mistake in computation. The taxpayer appealed to the Court of Appeals for the second circuit, which reversed the decision of the Board and held the gift exempt. 58 F.(2d) 188. The case is here on certiorari.

On November 8, 1924, more than eight months before the cancellation of the power of revocation, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, adopted and promulgated the following regulation. "The creation of a trust, where the grantor retains the power to revest in himself title to the corpus of the trust, does not constitute a gift subject to tax, but the annual income of the trust which is paid over to the beneficiaries shall be treated as a taxable gift for the year in which so paid. Where the power retained by the grantor to revest in himself title to the corpus is not exercised, a taxable transfer will be treated as taking place in the year in which such power is terminated." Regulations 67, Article I.

The substance of this regulation has now been carried forward into the Revenue Act of 1932, which will give the rule for later transfers.[1]

We think the regulation, and the later statute continuing it, are declaratory of the law which Congress meant to establish in 1924.

"Taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed — the actual benefit for which the tax is paid." *Corliss* v. *Bowers*, 281 U.S. 376, 378. . . . While the powers of revocation stood uncanceled in the deeds, the gifts, from the point of view of substance, were inchoate and imperfect. By concession there would have been no gift in any aspect if the donor had attempted to attain the same result by the mere delivery of the securities into the hands of the donees. A power of revocation accompanying delivery would have made the gift a nullity. *Basket* v. *Hassell*, 107 U.S. 602. By the execution of deeds and the creation of trusts, the settlor did indeed succeed in divesting himself of title and transferring it to

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[1] Sec. 501(c): "The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift."

others . . . but the substance of his dominion was the same as if these forms had been omitted. *Corliss* v. *Bowers*, *supra*. He was free at any moment, with reason or without, to revest title in himself, except as to any income then collected or accrued. As to the principal of the trusts and as to income to accrue thereafter, the gifts were formal and unreal. They acquired substance and reality for the first time in July, 1925, when the deeds became absolute through the cancellation of the power.

The argument for the respondent is that Congress in laying a tax upon transfers by gift made in 1924 or in any year thereafter had in mind the passing of title, not the extinguishment of dominion. In that view the transfer had been made in 1917 when the deeds of trust were executed. The argument for the Government is that what was done in 1917 was preliminary and tentative, and that not till 1925 was there a transfer in the sense that must have been present in the mind of Congress when laying a burden upon gifts. Petitioner and respondent are at one in the view that from the extinguishment of the power there came about a change of legal rights and a shifting of economic benefits which Congress was at liberty, under the Constitution, to tax as a transfer effected at that time. . . . The question is not one of legislative power. It is one of legislative intention.

With the controversy thus narrowed, doubt is narrowed too. Congress did not mean that the tax should be paid twice, or partly at one time and partly at another. If a revocable deed of trust is a present transfer by gift, there is not another transfer when the power is extinguished. If there is not a present transfer upon the delivery of the revocable deed, then there is such a transfer upon the extinguishment of the power. There must be a choice, and a consistent choice, between the one date and the other. To arrive at a decision, we have therefore to put to ourselves the question, which choice is it the more likely the Congress would have made? Let us suppose a revocable transfer made on June 3, 1924, the day after the adoption of the Revenue Act of that year. Let us suppose a power of revocation still uncanceled, or extinguished years afterwards, say in 1931. Did Congress have in view the present payment of a tax upon the full value of the subject matter of this imperfect and inchoate gift? The statute provides that upon a transfer by gift the tax upon the value shall be paid by the donor (43 Stat. 316, c. 234, §324), and shall constitute a lien upon the property transferred. 43 Stat. c. 234, §§324, 315. By the act now in force, the personal liability for payment extends to the donee. Act of June 6, 1932, c. 209, §510; 47 Stat. 249; 26 U.S. Code, §1136(j).* A statute will be construed in such a way as to avoid unnecessary hardship when its meaning is uncertain. *Hawaii* v. *Mankichi*, 190 U.S. 197, 214; *Sorrells* v. *United States*, 287 U.S. 435. Hardship there plainly is in exacting the immediate payment of a tax upon the value of the principal when nothing has been done to give assurance that any part of the principal will ever go to the donee. The statute is not aimed at every transfer of the legal title without consideration. Such a transfer there would be if the trustees were to hold for the use of the grantor. It is aimed at transfers of the

* The corresponding provisions of the 1954 Code are § 2502(d) (donor to pay tax) and § 6324(b) (gift tax lien; donee personally liable to the extent of the value of the gift). [Ed.]

title that have the quality of a gift, and a gift is not consummate until put beyond recall.

The respondent invokes the rule that in the construction of a taxing act doubt is to be resolved in favor of the taxpayer. *United States* v. *Merriam*, 263 U.S. 179; *Gould* v. *Gould*, 245 U.S. 151. There are many facets to such a maxim. One must view them all, if one would apply it wisely. The construction that is liberal to one taxpayer may be illiberal to others. One must strike a balance of advantage. It happens that the taxpayer before us made his deeds in 1917, before a transfer by gift was subject to a tax. We shall alleviate his burden if we say that the gift was then complete. On the other hand, we shall be heightening the burdens of taxpayers who made deeds of gift after the Act of 1924. In making them, they had the assurance of a treasury regulation that the tax would not be laid, while the power of revocation was uncanceled, except upon the income paid from year to year. They had good reason to suppose that the tax upon the principal would not be due until the power was extinguished or until the principal was paid. If we disappoint their expectations, we shall be illiberal to them.

The tax upon gifts is closely related both in structure and in purpose to the tax upon those transfers that take effect at death. What is paid upon the one is in certain circumstances a credit to be applied in reduction of what will be due upon the other, 43 Stat. 315, §322, 26 U.S.C. §1134.* The gift tax is Part II of Title III of the Revenue Act of 1924; the Estate Tax is Part I of the same title. The two statutes are plainly *in pari materia*. There has been a steady widening of the concept of a transfer for the purpose of taxation under the provisions of Part I. . . . There is little likelihood that the lawmakers meant to narrow the concept, and to revert to a construction that would exalt the form above the substance, in fixing the scope of a transfer for the purposes of Part II. We do not ignore differences in precision of definition between the one part and the other. They cannot obscure identities more fundamental and important. The tax upon estates, as it stood in 1924, was the outcome of a long process of evolution; it had been refined and perfected by decisions and amendments almost without number. The tax on gifts was something new. Even so, the concept of a transfer, so painfully developed in respect of taxes on estates, was not flung aside and scouted in laying this new burden upon transfers during life. Congress was aware that what was of the essence of a transfer had come to be identified more nearly with a change of economic benefits than with technicalities of title. The word had gained a new color, the result, no doubt in part, of repeated changes of the statutes, but a new color none the less. . . .

The respondent finds comfort in the provisions of §302(d) of the Act of 1924, governing taxes on estates.[2] He asks why such a provision should have been

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* Sec. 2012, 1954 Code; *infra*, p. 1230. [Ed.]

[2] By section 302(d), the gross estate of a decedent is to be taken as including the subject of any trust which he has created during life "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for a fair consideration in money or money's worth."

placed in Part I and nothing equivalent inserted in Part II, if powers for purposes of the one tax were to be treated in the same way as powers for the purposes of the other. Section 302(d) of the Act of 1924 is in part a reenactment of a section of the Revenue Acts of 1918 and 1921, though it has been changed in particulars. . . . It is an outcome of that process of development which has given us a rule for almost every imaginable contingency in the assessment of a tax under the provisions of Part I. No doubt the draftsman of the statute would have done well if he had been equally explicit in the drafting of Part II. This is not to say that meaning has been lost because extraordinary foresight would have served to make it clearer. Here as so often there is a choice between uncertainties. We must be content to choose the lesser. To lay the tax at once, while the deed is subject to the power, is to lay it on a gift that may never become consummate in any real or beneficial sense. To lay it later on is to unite benefit with burden. We think the voice of Congress has ordained that this be done. . . .

The argument for the respondent, if pressed to the limit of its logic would carry him even farther than he had claimed the right to go. If his position is sound that a power to revoke does not postpone for the purpose of taxation the consummation of the gift, then the income of these trusts is exempt from the tax as fully as the principal. What passed to the beneficiaries was the same in either case, an interest inchoate and contingent till rendered absolute and consummate through receipt or accrual before the act of revocation. Congress did not mean that recurring instalments of the income, payable under a revocable conveyance which had been made by a settlor before the passage of this statute, should be exempt, when collected, from the burden of the tax.

The judgment is reversed.

THE CHIEF JUSTICE took no part in the consideration or decision of this case.

MR. JUSTICE SUTHERLAND and MR. JUSTICE BUTLER are of opinion that the termination of the donor's power of revocation was not a transfer by gift of any property within the meaning of the statute, and that the judgment of the Circuit Court of Appeals should be affirmed.

Note

1. Because the Supreme Court in the *Guggenheim* case expressed the opinion that §501(c) of the 1932 Revenue Act (providing that a revocable transfer is not a taxable gift) was declaratory only, *supra*, p. 914, it was repealed in 1934.

2. A gift may be subject to recall because the donor was *non compos mentis*, because he failed to make an effective delivery of the property or to comply with laws like the statute of frauds, because the transfer was procured by fraud, and so on. Is there a taxable gift if there is no time limit on the power of the donor to recover the donated property? If the transfer has not been nullified at the time of the donor's death, the

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By section 302(h), the foregoing subdivision (d), as well as many others, is declared to "apply to the transfers, trusts, estates, interests, rights, powers, and relinquishments of powers, as severally enumerated and described therein, whether made, created, arising, existing, exercised, or relinquished before or after the enactment of this act."

[The corresponding provisions of the 1954 Code are §2038(a) and §2044. Ed.]

property may be part of his gross estate and become subject to the estate tax. See *infra*, p. 973. Is a gift tax due if the donor's creditors, but not the donor himself, can set the transfer aside?

In *Commissioner* v. *Allen*, 108 F.2d 961, cert. den., 309 U.S. 680 (1940), the court had to decide the proper time for imposing the gift tax on a transfer made by the taxpayer while he was a minor. The applicable local law allowed a minor to recover property transferred by gift at any time before reaching the age of 21 and for a "reasonable time" (depending "on the circumstances of the particular case") thereafter. The transfer occurred in 1932, before the gift tax law was enacted; the government assessed a deficiency for 1933, when the taxpayer became 21. The court rejected the taxpayer's argument that the gift was made in 1932 and upheld the assessment for 1933. But there was no contention that the gift occurred in a *later* year:

> The respondent [taxpayer] suggests that a ruling, that a minor's transfer in trust does not become taxable until the minor attains majority and fails to disaffirm, will lead to difficulties in administration with respect to the date of taxability of a transfer in view of the varying periods allowed minors for disaffirmance after majority. No such difficulty arises from the record in this case The respondent objected neither to the Commissioner's determination of the date the transfer became complete as a gift nor to the valuation placed upon the securities embraced by the transfer. Moreover, the period of the New Jersey statute of limitations, the utter conceivable limit of the respondent's right to disaffirm, expired on October 9, 1939, without an effort at disaffirmance on her part. In any event, for the Commissioner to promulgate a regulation with respect to a minor's transfer in trust that will fully protect the minor's free exercise of his right to disaffirm after majority should not present insuperable difficulty. (108 F.2d at 966.)

No regulation of this type has been issued.

3. In *Commissioner* v. *Procter*, 142 F.2d 824 (4th Cir. 1944), the court had to pass on the effect of a gift of property the title to which was to revert to the donor should the transfer be determined to be subject to federal gift tax:

> The third point is based upon the following provision of the trust indenture making the gift, *viz.*:
>
> "Eleventh The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created."
>
> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.
>
> The condition is contrary to public policy for three reasons. In the first place, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax

would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court....

In the third place the condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax.* The only way, therefore, in which it could be determined by "final judgment" of a federal court of last resort that any part of a transfer was subject to a gift tax would be for a tax to be assessed by the Commissioner and upheld by such court in the course of legal proceedings instituted for its enforcement or for its recovery after payment. This final judgment would fix the liability of the donor for the tax; and only then could the condition become operative. The condition, however, could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment. To state the matter differently, the condition is not to become operative until there has been a judgment, but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment.

Harrison v. *Commissioner*, 17 T.C. 1350 (1952), involved a gift in trust under which the trustee was to pay out of the corpus any gift tax levied on the transfer. The Court held:

One of the essential elements of a gift is the donor's intent to make the gift. Petitioner did not intend that the amount of the value of a property necessary for the gift tax liability would be a gift to the trust. Therefore, in the absence of an intent to give, this amount was not effective as property passing from the donor, and not taxable as a gift.

COMMISSIONER v. WEMYSS

Supreme Court of the United States, 1945
324 U.S. 303

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

In 1939 taxpayer proposed marriage to Mrs. More, a widow with one child. Her deceased husband had set up two trusts, one half the income of which was for the benefit of Mrs. More and the other half for that of the child with provision that, in the event of Mrs. More's remarriage, her part of the income ceased and went to the child. The corpus of the two trusts consisted of stock which brought to Mrs. More from the death of her first husband to her remarriage, about five years later, an average income of $5,484 a year. On Mrs. More's unwillingness to suffer loss of her trust income through remarriage the parties on May 24, 1939, entered upon an agreement whereby taxpayer trans-

* *Supra*, p. 831. [Ed.]

ferred to Mrs. More a block of shares of stock. Within a month they married. The Commissioner ruled that the transfer of this stock, the value of which, $149,456.13, taxpayer does not controvert, was subject to the Federal Gift Tax. Accordingly, he assessed a deficiency which the Tax Court upheld, 2 T.C. 876, but the Circuit Court of Appeals reversed the Tax Court, 144 F.2d 78. We granted certiorari to settle uncertainties in tax administration engendered by seemingly conflicting decisions. 323 U.S. 703.

The answer to our problem turns on the proper application of §§501(a) and 503 [§§2501(a) and 2512(b), 1954 Code] to the immediate facts. These provisions are as follows:

Sec 501. Imposition of Tax.

(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual . . . of property by gift.

Sec. 503. Transfer for Less Than Adequate and Full Consideration.

Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

In view of the major role which the Tax Court plays in federal tax litigation, it becomes important to consider how that court dealt with this problem. Fusing, as it were, §§501 and 503, the Tax Court read them as not being limited by any common law technical notions about "consideration." And so, while recognizing that marriage was of course a valuable consideration to support a contract, the Tax Court did not deem marriage to satisfy the requirement of §503 in that it was not a consideration reducible to money value. Accordingly, the Court found the whole value of the stock transferred to Mrs. More taxable under the statute and the relevant Treas. Reg. 79 (1936 Ed.) Art. 8: "A consideration not reducible to a money value, as love and affection, promise of marriage, *etc.*, is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." In the alternative, the Tax Court was of the view that if Mrs. More's loss of her trust income rather than the marriage was consideration for the taxpayer's transfer of his stock to her, he is not relieved from the tax because he did not receive any money's worth from Mrs. More's relinquishment of her trust income, and, in any event, the actual value of her interest in the trust, subject to fluctuations of its stock earnings, was not proved. One member of the Tax Court dissented, deeming that the gift tax legislation invoked ordinary contract conceptions of "consideration."

The Circuit Court of Appeals rejected this line of reasoning. It found in the marriage agreement an arm's length bargain and an absence of "donative intent" which it deemed essential: "A donative intent followed by a donative act is essential to constitute a gift, and no strained and artificial construction of a supplementary statute should be indulged to tax as a gift a transfer actually lacking donative intent." 144 F.(2d) 78, 82.

Sections 501 and 503 are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress

taxed "gifts" *simpliciter*, it would be appropriate to assume that the term was used in its colloquial sense, and a search for "donative intent" would be indicated. But Congress intended to use the term "gifts" in its broadest and most comprehensive sense. H. Rep. No. 708, 72nd Cong., 1st Sess., p. 27;* S. Rep. No. 665, 72nd Cong., 1st Sess., p. 39; *cf. Smith* v. *Shaughnessy*, 318 U.S. 176; *Robinette* v. *Helvering*, 318 U.S. 184. Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent." It formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift. . . ." And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax.[1]

To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is *bona fide*, at arm's length, and free from any donative intent)." Treas. Reg. 79 (1936 Ed.) Art. 8. Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an adequate and full consideration in money or money's worth." See 2 Paul, *Federal Estate and Gift Taxation* (1942) p. 1113.

The Tax Court in effect found the transfer of the stock to Mrs. More was not made at arm's length in the ordinary course of business. It noted that the inducement was marriage, took account of the discrepancy between what she got and what she gave up, and also of the benefit that her marriage settlement brought to her son. These were considerations the Tax Court could justifiably heed, and heeding, decide as it did. Its conclusion on the issue before it was no less to be respected than were the issues which we deemed it was entitled to decide as it did in *Dobson* v. *Commissioner*, 320 U.S. 489, *Commissioner* v. *Heininger*, 320 U.S. 467, *Commissioner* v. *Scottish American Co.*, 323 U.S. 119.

If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct. See *Commissioner* v. *Bristol*, 121 F.2d 129. To be sure, the Revenue Act of 1932 does not spell out a requirement of benefit to the transferor to afford relief from the gift tax. Its forerunner, §320 of the 1924 Act, 43 Stat. 253, 314, was more explicit in that it provided that the excess of the transfer over "the consideration received shall . . . be deemed a gift." It will hardly be suggested, however, that in re-imposing the gift tax in 1932 Congress meant to exclude

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* *Supra*, p. 913. [Ed.]

[1] Treas Reg 79 (1936 Ed) Art. 1· "*Imposition of tax.* . . . The tax is not limited in its imposition to transfers of property without a valuable consideration, which at common law are treated as gifts, but extends to sales and exchanges for less than an adequate and full consideration in money or money's worth."

transfers that would have been taxed under the 1924 Act. The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. To allow detriment to the donee to satisfy the requirement of "adequate and full consideration" would violate the purpose of the statute and open wide the door for evasion of the gift tax. See 2 Paul, *supra*, at 1114.

Reversed.

MR. JUSTICE ROBERTS dissents, and would affirm the judgment for the reasons given in the opinion of the Circuit Court of Appeals.

MERRILL v. FAHS

Supreme Court of the United States, 1945
324 U.S. 308

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

This is a companion case to *Commissioner* v. *Wemyss*, *ante*, p. 303.

On March 7, 1939, taxpayer, the petitioner, made an antenuptial agreement with Kinta Desmare. Taxpayer, a resident of Florida, had been twice married and had three children and two grandchildren. He was a man of large resources, with cash and securities worth more than $5,000,000, and Florida real estate valued at $135,000. Miss Desmare's assets were negligible. By the arrangement entered into the day before their marriage, taxpayer agreed to set up within ninety days after marriage an irrevocable trust for $300,000, the provisions of which were to conform to Miss Desmare's wishes. The taxpayer was also to provide in his will for two additional trusts, one, likewise in the amount of $300,000, to contain the same limitations as the *inter vivos* trust, and the other, also in the amount of $300,000, for the benefit of their surviving children. In return Miss Desmare released all rights that she might acquire as wife or widow in taxpayer's property, both real and personal, excepting the right to maintenance and support. The inducements for this agreement were stated to be the contemplated marriage, desire to make fair requital for the release of marital rights, freedom for the taxpayer to make appropriate provisions for his children and other dependents, the uncertainty surrounding his financial future and marital tranquillity. That such an antenuptial agreement is enforceable in Florida is not disputed, *North* v. *Ringling*, 149 Fla. 739, 7 So.2d 476, nor that Florida gives a wife an inchoate interest in all the husband's property contingent during his life but absolute upon death. Florida Statutes (1941) §731.34; *Smith* v. *Hines*, 10 Fla. 258; *Henderson* v. *Usher*, 125 Fla. 709, 170 So. 846. The parties married, and the agreement was fully carried out.

On their gift tax return for 1939, both reported the creation of the trust but claimed that no tax was due. The Commissioner, however, determined a deficiency of $99,000 in taxpayer's return in relation to the transfer of the $300,000. Upon the Commissioner's rejection of the taxpayer's claim for refund of the assessment paid by him, the present suit against the Collector was filed. The District Court sustained the taxpayer, 51 F.Supp. 120, but was reversed by the Circuit Court of Appeals for the Fifth Circuit, one judge dissenting. 142

F.2d 651. We granted certiorari in connection with *Commissioner* v. *Wemyss*, *supra*, and heard the two cases together. 323 U.S. 686.

This case, unlike the *Wemyss* case, does not come here by way of the Tax Court. No aid can therefore be drawn from a prior determination by the tribunal specially entrusted with tax adjudications. (See Griswold, The Need for a Court of Tax Appeals (1944) 57 *Harv. L. Rev.* 1153, 1173.) But like the *Wemyss* case, this case turns on the proper application of §503 of the Revenue Act of 1932. In the interest of clarity we reprint it here: "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year." Taxpayer claims that Miss Desmare's relinquishment of her marital rights constituted "adequate and full consideration in money or money's worth." The Collector, relying on the construction of a like phrase in the estate tax, contends that release of marital rights does not furnish such "adequate and full consideration."

We put to one side the argument that in any event Miss Desmare's contingent interest in her husband's property had too many variables to be reducible to dollars and cents, and that any attempt to translate it into "money's worth" was "mere speculation bearing the delusive appearance of accuracy." *Humes* v. *United States*, 276 U.S. 487, 494. We shall go at once to the main issue.

The guiding light is what was said in *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, 44: "The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together." The phrase on the meaning of which decision must largely turn—that is, transfers for other than "an adequate and full consideration in money or money's worth"—came into the gift tax by way of estate tax provisions. It first appeared in the Revenue Act of 1926. Section 303(a)(1) of that Act, 44 Stat. 9, 72, allowed deductions from the value of the gross estate of claims against the estate to the extent that they were *bona fide* and incurred "for an adequate and full consideration in money or money's worth." [§2053(c)(1)(A), 1954 Code.] It is important to note that the language of previous Acts which made the test "fair consideration" was thus changed after courts had given "fair consideration" an expansive construction.

The first modern estate tax law included in the gross estate transfers in contemplation of, or intended to take effect in possession or enjoyment at, death, except "a bona fide sale for a fair consideration in money or money's worth." §202(b), Revenue Act of 1916, 39 Stat. 756, 777. Dower rights and other marital property rights were intended to be included in the gross estate, since they were considered merely an expectation, and in 1918 Congress specifically included them. §402(b), 40 Stat. 1057, 1097. This provision was for the purpose of clarifying the existing law. H. Rep. No. 767, 65th Cong., 2d Sess., p.21. In 1924 Congress limited deductible claims against an estate to those supported by "a fair consideration in money or money's worth," §303(a)(1), 43 Stat. 253, 305, employing the same standard applied to transfers in contemplation of death, H. Rep. No. 179, 68th Cong., 1st Sess., pp.28, 66. Similar language was used in the gift tax, first imposed by the 1924 Act, by providing, "Where property is sold

or exchanged for less than a fair consideration in money or money's worth" the excess shall be deemed a gift. §320, 43 Stat. 253, 314.

The two types of tax thus followed a similar course, like problems and purposes being expressed in like language. In this situation, courts held that "fair consideration" included relinquishment of dower rights. *Ferguson* v. *Dickson*, 300 F. 961; and see *McCaughn* v. *Carver*, 19 F.2d 126; *Stubblefield* v. *United States*, 6 F.Supp. 440 Congress was thus led, as we have indicated, to substitute in the 1926 Revenue Act, the words "adequate and full consideration" in order to narrow the scope of tax exemptions. See *Taft* v. *Commissioner*, 304 U.S. 351, 356. When the gift tax was re-enacted in the 1932 Revenue Act, the restrictive phrase "adequate and full consideration" as found in the estate tax was taken over by the draftsman.

To be sure, in the 1932 Act Congress specifically provided that relinquishment of marital rights for purposes of the estate tax shall not constitute "consideration in money or money's worth." [§2043(b), 1954 Code.] The Committees of Congress reported that if the value of relinquished marital interests "may, in whole or in part, constitute a consideration for an otherwise taxable transfer (as has been held to be so), or an otherwise unallowable deduction from the gross estate, the effect produced amounts to a subversion of the legislative intent. . . ." H. Rep. No. 708, 72d Cong., 1st Sess., p. 47; S. Rep. No. 665, 72d Cong., 1st Sess., p. 50. Plainly, the explicitness was one of cautious redundancy to prevent "subversion of the legislative intent." Without this specific provision, Congress undoubtedly intended the requirement of "adequate and full consideration" to exclude relinquishment of dower and other marital rights with respect to the estate tax. *Commissioner* v. *Bristol*, 121 F.2d 129; *Sheets* v. *Commissioner*, 95 F.2d 727.

We believe that there is every reason for giving the same words in the gift tax the same reading. Correlation of the gift tax and the estate tax still requires legislative intervention. *Commissioner* v. *Prouty*, 115 F.2d 331, 337; Warren, Correlation of Gift and Estate Taxes (1941) 55 *Harv. L. Rev.* 1; Griswold, A Plan for the Coordination of the Income, Estate and Gift Tax Provisions (1942) 56 *Harv. L. Rev.* 337. But to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation. Here strong reasons urge identical construction. To hold otherwise would encourage tax avoidance. *Commissioner* v. *Bristol*, *supra* at 136; 2 Paul, *Estate and Gift Taxation* (1942) p. 1118. And it would not fulfill the purpose of the gift tax in discouraging family settlements so as to avoid high income surtaxes. H. Rep. No. 708, 72d Cong., 1st Sess., p.28, S. Rep. No. 665, 72d Cong., 1st Sess., p.40. There is thus every reason in this case to construe the provisions of both taxes harmoniously. *Estate of Sanford* v. *Commissioner*, *supra*.[1]

Affirmed.

MR. JUSTICE ROBERTS dissents.

MR. JUSTICE REED, dissenting.

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[1] Treasury Regulations 79 (1936 Ed.) Art. 8 is inapplicable. To find that the transaction was "made in the ordinary course of business" is to attribute to the Treasury a strange use of English.

This case differs from *Commissioner* v. *Wemyss*, *ante*, p. 303. Whether the transferor of the sums paid for the release of dower and other marital rights, received adequate and full consideration in money and money's worth is a question of fact. The agreement recites that the parties contemplate marriage and provides that the trust shall be set up only in the event of and following the marriage. Petitioner was obligated to create the trust upon consideration of the relinquishment of marital rights and did so, and hence this is not a case involving marriage alone as consideration. Through the tables of mortality, the value of a survivor's right in a fixed sum receivable at the death of the second party may be adequately calculated. By adopting present value as the accepted future value, the uncertainty inherent in fluctuations of an estate's value is theoretically eliminated. The trial court thus found the present value of the release of the taxpayer's estate from the wife's survivorship rights largely exceeded the amount paid by the taxpayer and that the transactions between the parties were made in good faith for business reasons and not an attempt to evade or avoid taxes. Thus the District Court findings bring this transaction within the express language of the applicable Treasury Regulation.[1] *Merrill* v. *Fahs*, 51 Fed. Supp. 120. Its determination, we think, also makes it clear that the husband's estate received practical advantages of value in excess of the cost paid. See *Henderson* v. *Usher*, 125 Fla. 709, 727, 170 So. 846.

The question of the taxability as gifts of transfers to spouses in consideration of the release of marital rights had been a matter of dispute in courts before the passage of the Revenue Act of 1932, §503, 47 Stat. 169, 247. Congress in the 1932 act, §804, declared that a transfer of marital rights should not be "consideration in 'money or money's worth' " under the estate tax provisions. Thus Congress put beyond any question the liability of transferors for estate taxes where marital rights were the consideration for the transfer. On the other hand, in the same 1932 Revenue Act the language of the gift tax section, §503, did not have a provision forbidding the valuation of marital rights. Consequently, §503 as interpreted by Regulations 79, Art. 8, permits the treatment of the relinquishment of such rights, not donative in intent or effect, as "money's worth" consideration for property transferred. It seems to us clear that with the judicial history of the difficulties in estate and gift taxes as to the transfer of marital rights, when Congress expressly provided that relinquishment of dower, curtesy or other statutory estate was not "consideration" for estate tax purposes and left the gift tax provision without such a limitation, it intended that these

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[1] Treasury Regulations 79 (1936 Ed):

"Art. 8 *Transfers for a consideration in money or money's worth.*—Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration in money or money's worth to the extent that the value of the property transferred by the donor exceeds the value of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

rights be accorded a different treatment under these sections. This has been the determination of the Tax Court.[2]

In our view this judgment should be reversed.

The CHIEF JUSTICE and MR. JUSTICE DOUGLAS join in this dissent.

Note

1. Is the value of the prospective Mrs. Merrill's right to dower more conjectural than the dissenting justices acknowledge? The district judge's calculation is found in 51 F.Supp. at 120 and is criticized by the Court of Appeals in 142 F.2d at 651.

2. The relation of antenuptial settlements to income taxation is discussed in *Farid-Es-Sultaneh* v. *Commissioner*, *supra*, p. 108. Does it follow from that case that Mr. Kresge realized income in 1923 and 1924, because he exchanged the stock for the release of dower, to the extent of the difference between (a) his cost basis for the shares and (b) their value (or the value of the released rights) at the time of the transfer? Should he have paid both an income tax and a gift tax on the transfer?

HARRIS v. COMMISSIONER

Supreme Court of the United States, 1950
340 U.S. 106

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The federal estate tax and the federal gift tax, as held in a line of cases ending with *Commissioner* v. *Wemyss*, 324 U.S. 303, and *Merrill* v. *Fahs*, 324 U.S. 308, are construed in pari materia, since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime. Both the gift tax * and the estate tax † exclude transfers made for "an adequate and full consideration in money or money's worth." In the estate tax this requirement is limited to deductions for claims based upon "a promise or agreement"; but the consideration for the "promise or agreement" may not be the release of marital rights in the decedent's property.‡ In the *Wemyss* and *Merrill* cases the question was whether the gift tax was applicable to premarital property settlements. If the standards of the estate tax were to be applied ex proprio vigore in gift tax cases, those transfers would be taxable because there was a "promise or agreement" touching marital rights in property. We sustained the tax, thus giving "adequate and full consideration in money or money's worth" the same meaning under both statutes insofar as premarital property settlements or agreements are concerned.

The present case raises the question whether *Wemyss* and *Merrill* require the imposition of the gift tax in the type of post-nuptial settlement of property rights involved here.

Petitioner divorced her husband, Reginald Wright, in Nevada in 1943. Both

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[2] Bristol v. Commissioner, 42 B.T.A. 263; Jones v. Commissioner, 1 T.C. 1207; Wemyss v. Commissioner, 2 T.C. 876, 881.

* § 2512(b), 1954 Code. [Ed]

† § 2053(c)(1)(A), 1954 Code. [Ed.]

‡ § 2043(b), 1954 Code. [Ed.]

she and her husband had substantial property interests. They reached an understanding as respects the unscrambling of those interests, the settlement of all litigated claims to the separate properties, the assumption of obligations, and the transfer of properties.

Wright received from petitioner the creation of a trust for his lifetime of the income from her remainder interest in a then existing trust, an assumption by her of an indebtedness of his of $47,650; and her promise to pay him $416.66 a month for ten years.

Petitioner received from Wright 21/90 of certain real property in controversy; a discontinuance of a partition suit then pending; an indemnification from and assumption by him of all liability on a bond and mortgage on certain real property in London, England; and an indemnification against liability in connection with certain real property in the agreement. It was found that the value of the property transferred to Wright exceeded that received by petitioner by $107,150. The Commissioner assessed a gift tax on the theory that any rights which Wright might have given up by entering into the agreement could not be adequate and full consideration.

If the parties had without more gone ahead and voluntarily unravelled their business interests on the basis of this compromise, there would be no question but what the gift tax would be payable. For there would have been a "promise or agreement" that effected a relinquishment of marital rights in property. It therefore would fall under the ban of the provision of the estate tax which by judicial construction has been incorporated into the gift tax statute.

But the parties did not simply undertake a voluntary contractual division of their property interests. They were faced with the fact that Nevada law not only authorized but instructed the divorce court to decree a just and equitable disposition of both the community and the separate property of the parties.[1] The agreement recited that it was executed in order to effect a settlement of the respective property rights of the parties " in the event a divorce should be decreed"; and it provided that the agreement should be submitted to the divorce court "for its approval." It went on to say, "It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the Recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action."

If the agreement had stopped there and were in fact submitted to the court, it is clear that the gift tax would not be applicable. That arrangement would not be a "promise or agreement" in the statutory sense. It would be wholly conditional upon the entry of the decree; the divorce court might or might not accept the provisions of the arrangement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the

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[1] At the time of the divorce Nevada Compiled Laws, § 9463 provided: "In granting a divorce the court may award such alimony to the wife and shall make such a disposition of the community and separate property of the parties as shall appear just and equitable, having regard to the respective merits of the parties and to the condition in which they will be left by such divorce, and to the party through whom the property was acquired, and to the burdens, if any, imposed upon it for the benefit of the children. . . ."

arrangement submitted to the court, would fix the rights and obligations of the parties. That was the theory of *Commissioner* v. *Maresi*, 156 F.2d 929, and we think it sound.

Even the Commissioner concedes that the result would be correct in case the property settlement was litigated in the divorce action. That was what happened in *Commissioner* v. *Converse*, 163 F.2d 131, where the divorce court decreed a lump sum award in lieu of monthly payments provided by the separation agreement. Yet without the decree there would be no enforceable, existing agreement whether the settlement was litigated or unlitigated. Both require the approval of the court before an obligation arises. The happenstance that the divorce court might approve the entire settlement, or modify it in unsubstantial details, or work out material changes seems to us unimportant. In each case it is the decree that creates the rights and the duties; and a decree is not a "promise or agreement" in any sense—popular or statutory.

But the present case is distinguished by reason of a further provision in the undertaking and in the decree. The former provided that "the covenants in this agreement shall survive any decree of divorce which may be entered." And the decree stated "It is ordered that said agreement and said trust agreements forming a part thereof shall survive this decree." The Court of Appeals turned the case on those provisions. It concluded that since there were two sanctions for the payments and transfers—contempt under the divorce decree and execution under the contract—they were founded not only on the decree but upon both the decree and a "promise or agreement." It therefore held the excess of the value of the property which petitioner gave her husband over what he gave her to be taxable as a gift. 178 F 2d 861.

We, however, think that the gift tax statute is concerned with the source of rights, not with the manner in which rights at some distant time may be enforced. Remedies for enforcement will vary from state to state. It is "the transfer" of the property with which the gift tax statute is concerned, not the sanctions which the law supplies to enforce transfers. If "the transfer" of marital rights in property is effected by the parties, it is pursuant to a "promise or agreement" in the meaning of the statute. If "the transfer" is effected by court decree, no "promise or agreement" of the parties is the operative fact In no realistic sense is a court decree a "promise or agreement" between the parties to a litigation. If finer, more legalistic lines are to be drawn, Congress must do it.

If, as we hold, the case is free from any "promise or agreement" concerning marital rights in property, it presents no remaining problems of difficulty. The Treasury Regulations [2] recognize as tax free "a sale, exchange, or other transfer

[2] Section 86 8 of Treas. Reg 108 provides: "Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration in money or money's worth to the extent that the value of the property transferred by the donor exceeds the value of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a money value, as love and affection, promise of marriage, *etc.*, is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent)." This transaction is not "in the ordinary course of business" in any conventional sense. Few transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax. . . .

Reversed.

MR. JUSTICE FRANKFURTER, whom MR. JUSTICE BLACK, MR. JUSTICE BURTON, and MR. JUSTICE MINTON join, dissenting.

Section 503 of the Revenue Act of 1932 imposes a gift tax on property "transferred for less than an adequate and full consideration in money or money's worth." In *Merrill* v. *Fahs*, 324 U.S. 308, the Court held that an antenuptial settlement is subject to this tax. Believing as I do that the disposition of the case before us largely depends on the weight given to the considerations which there prevailed, recapitulation of them is appropriate. The Court there based its result on the conclusion that a transfer of property pursuant to an antenuptial settlement was not made in exchange for an "adequate and full consideration in money or money's worth." This conclusion was reinforced by reading into the gift tax provision the gloss of the interrelated estate tax of the same year that the relinquishment of "marital rights . . . shall not be considered to any extent a consideration 'in money or money's worth.' "

The case before us concerns not an antenuptial agreement, but what the Tax Court called a "property settlement agreement," contracted in anticipation of divorce. Each spouse transferred property of substantial value to the other and each agreed "to release completely the property of the other from all claims arising out of their marriage." 10 T.C. 741, 743.

Unless we are now to say that a settlement of property in winding up, as it were, a marriage, smacks more of a business arrangement than an antenuptial agreement and therefore satisfies the requirement of "an adequate and full consideration in money or money's worth" which we found wanting in *Merrill* v. *Fahs,* and unless we are further to overrule *Merrill* v. *Fahs* insofar as it joined the gift tax and the estate tax of the Revenue Act of 1932, so as to infuse into the gift tax the explicitness of the estate tax in precluding the surrender of marital rights from being deemed to any extent a consideration "in money or money's worth," we must hold that a settlement of property surrendering marital rights in anticipation of divorce is not made for "an adequate and full consideration in money or money's worth."

The same year that it enacted the gift tax Congress amended the estate tax by adding to the provision that "adequate and full consideration" was prerequisite to deduction of "claims against the estate" the phrase, "when founded upon a promise or agreement." Revenue Act of 1932, §805 [§2053(c)(1)(A), 1954 Code]. Legislative history demonstrates that this amendment was intended, not to

change the law, but to make clear that the requirement of consideration did not prevent "deduction of liabilities imposed by law or arising out of torts." H.R. Rep. No 708, 72d Cong., 1st Sess. 48; S. Rep. No. 665, 72d Cong., 1st Sess. 51. A similar principle is implicit in the gift tax. By its statutory language and authoritative commentaries thereon Congress did not leave the incidence of the gift tax at large by entrusting its application to the play of subtleties necessary to finding a "donative intent." *Commissioner* v. *Wemyss*, 324 U.S. 303, 306. But while by the gift tax Congress meant "to hit all the protean arrangements which the wit of man can devise that are not business transactions" to the common understanding, *Commissioner* v. *Wemyss*, *ibid.*, a gift tax is an exaction which does presuppose the voluntary transfer of property and not a transfer in obedience to law. In *Merrill* v. *Fahs*, *supra*, at 313, we stated that "to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation." Application of that principle would require the Court to hold that §503 of the Revenue Act of 1932 [§2512(b), 1954 Code] imposes a tax on "the amount by which the value of the property [transferred exceeds] the value of the consideration" received only when the transfer is "founded upon a promise or agreement." The taxpayer does not contest applicability of the principle; and in the view we take of the case it may be assumed.[3] Taxpayer contends (1) that the transfers in the situation now before us were or must be deemed to have been for an "adequate and full consideration in money or money's worth," and (2) that the Commissioner imposed a liability which was not "founded upon a promise or agreement." Her position was sustained by the Tax Court, 10 T.C. 741, but rejected by the Court of Appeals for the Second Circuit. 178 F.2d 861.

1. I would adhere to the views we expressed in the *Wemyss* and *Merrill* decisions as to the meaning to be given to the requirement of "adequate and full consideration" in the enforcement of the gift tax "in order to narrow the scope of tax exemptions." 324 U.S. at 312. Nor would I depart from the conclusion there reached that the relinquishment of marital rights is not to be deemed "money or money's worth" because that definition in the estate tax of 1932 is by implication to be read into the gift tax passed in the same year.

2. But was the transfer of the property here in controversy "founded upon a promise or agreement?" The answer requires recital of the governing facts of the case.

Taxpayer separated from her husband in August, 1942, and shortly thereafter brought suit in Nevada for divorce. One week prior to entry of the divorce decree, she and her husband entered into an agreement "for the purpose of settling the respective property rights of the parties hereto and of removing the

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[3] We therefore need not pass on the suggestion in the Government's brief that the estate and gift tax provisions should not in this instance be read in pari materia because the interpretation of a phrase common to the two statutes is not involved Nor do we pass on the contention that under both gift and estate taxes liability is imposed on transfers and claims resulting from loss of marital rights even when no promise or agreement is involved.

subject matter thereof from the field of litigation" After providing for the transfers of property and the release of claims, the agreement recited,

This agreement shall be submitted to the court for its approval, but nevertheless the covenants in this agreement shall survive any decree of divorce which may be entered. It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the Recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action. The settlement herein provided shall become immediately effective and operative in the event of and upon the entry of a decree of divorce between said parties in said pending Nevada action. The parties hereto, however, shall proceed as expeditiously as possible to carry into effect the covenants herein, which it is provided are to be performed by either of the parties prior to the entry of the decree as aforesaid.

After a hearing at which both parties were represented, the court granted the divorce. It found that certain transfers from the wife to the husband were "in discharge of a legal obligation which, because of the marital relationship has been imposed" on her; and concluded that "the agreement and trust agreements forming a part thereof, made and entered into between plaintiff and defendant under date of February 27th, 1943 is entitled to be approved." The divorce decree "approved" the agreement, directed performance of two of its paragraphs, and declared,

Notwithstanding the approval of said agreement and the trust agreements forming a part thereof by the Court herein, it is ordered that said agreement and said trust agreements forming a part thereof shall survive this decree. . . .

It is further ordered, adjudged and decreed that the decree herein entered is absolute and final in all respects and the Court herein divests itself of all power to amend or modify the same in the future without the consent of both of the parties hereto.

The parties executed the provisions of the decree and the agreement, and the Commissioner assessed the tax in question on the amount by which the value of the property transferred by the wife to her husband exceeded the value of the property transferred by him to her.

3. Such being the facts of the case, was the transfer by Cornelia Harris "founded upon a promise or agreement?" The statute does not say founded "solely upon a promise or agreement." The statute does not say that the tax should not fall on "property transferred under the terms of a judgment or decree of the court." Nor is the phrase "founded upon agreement" a technical term having a well-known meaning either in law or in literature. The question really is whether the transfer made by the taxpayer to her husband was, within the fair meaning of the language, "founded" upon her agreement with her husband. Did the Nevada judge in decreeing the divorce describe what actually took place here when he said that on the "date of February 27, 1943, the plaintiff and defendant entered into an agreement and trust agreements forming a part thereof, under the terms of which the parties settled all obligations arising out of their marriage?"

The fact that undertakings defined by this agreement would come into force only on the occurrence of a condition, to wit, the entering of a decree of divorce, is apparently regarded as decisive of taxability. But does this make any real difference? The terms of that decree might be different from the terms of the

agreement; but "nevertheless the covenants in this agreement shall survive any decree of divorce which may be entered." If the divorce court had disapproved the agreement and had not decreed the transfer of any property of the wife to her husband, it is difficult to see how transfers which she made, solely because of the compulsion of the agreement, would be effected by court decree and for that reason not subject to tax. The condition on which an agreement comes into force does not supplant an agreement any more than a deed in escrow ceases to be a deed when it comes out of escrow. In the *Wemyss* and *Merrill* cases would the gifts have been any the less founded upon an agreement if, as a condition to the antenuptial arrangements in those cases, the consent of the parents of the fiancée had been made a condition of the marriage? Nor can excluding the transfers here involved from the gift tax be made tenable by resting decision on the narrower ground that to the extent the divorce decree "approved" the agreement or embodied its provisions so as to make them enforceable by contempt the transfers were not "founded upon" the agreement within the meaning of the statute.[4] If the taxpayer had been sued by her husband for the sums she was obligated to transfer to him could he not have brought the suit on the contract?[5] Even though a promise for which inadequate consideration was given has been reduced to a judgment, a claim based upon it has been held not deductible from the gross estate and thus must have been deemed to be "founded upon a promise." *Markwell's Estate* v. *Commissioner*, 112 F.2d 253. If a transfer does not cease to be "founded upon a promise" when the promise is merged into a judgment, is not a transfer pursuant to an agreement which survives a ratifying decree a fortiori "founded upon" that agreement?

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[4] The ground adopted for reversal of the court below is important to the disposition of the case. On the broader ground apparently employed, no gift tax is due. But if the narrower basis be used, it is probable that some liability should be imposed. One of the transfers required by the agreement—the wife's assumption of a $47,650 indebtedness of her husband—was not incorporated into the divorce decree and therefore is presumably enforceable only under the contract. If enforceability under the decree is the criterion, a gift tax is due to the extent this indebtedness is reflected in the amount determined by the Commissioner to represent the value attributable to release of marital rights.

[5] In none of the twelve jurisdictions in which decisions in point have been found has it been held that a suit could not be brought on the contract in a situation like that before us. In four States actions may apparently be brought subsequent to divorce on prior separation agreements which are construed to contemplate survival even though the divorce decree directs different payments than the agreement. See Seuss v Schukat, 358 Ill. 27, 36, Freeman v. Sieve, 323 Mass. 652; Goldman v. Goldman, 282 N.Y. 296, 301; Holahan v. Holahan, 77 N.Y.S.2d 339; Mobley v. Mobley, 221 S.W.2d 565 (Tex. Civ. App.). In three States such suits may be brought at least where the decree is not inconsistent with the agreement and does not indicate an intention to terminate it. See Heinsohn v. Chandler, 23 Del. Ch. 114; Coe v. Coe, 71 A.2d 514 (Maine); Allen v. Allen, 196 Okla 36. In five others it appears that actions on the contract will lie except when the agreement is recited in the decree so as to be enforceable by contempt; but in none of the cases refusing to permit a suit on the contract did the decree or the agreement direct survival See Hough v Hough, 26 Calif. 2d 605, McWilliams v McWilliams, 110 Colo. 173; Hertz v Hertz, 136 Minn 188, Corbin v Mathews, 129 N.J. Eq 549; Mendelson v Mendelson, 123 Ohio St 11 See Lindey, *Separation Agreements* 389–95, Note, Control of Post-Divorce Level of Support by Prior Agreement, 63 *Harv. L. Rev.* 337. Schacht v. Schacht, 295 N Y. 439, relied on by petitioner, held only that a determination by the divorce court of the fairness of a separation agreement was res judicata in a subsequent suit to set the agreement aside for fraud. The issue does not appear to have been determined in Nevada, where the agreement here involved was made and the divorce entered.

Judge Learned Hand's treatment of this matter is so hard-headed and convincing that it would be idle to paraphrase his views.

In some jurisdictions contracts, made in anticipation of a divorce, are held to persist ex proprio vigore after the divorce decree has incorporated their terms, and has added its sanctions to those available in contract. That, for example, is the law of New York, where the contract remains obligatory even after the court has modified the allowances which it originally adopted; and where the promises will be thereafter enforced by execution and the like. Perhaps, that is also the law of Nevada, which the parties provided should govern "all matters affecting the interpretation of this agreement or the rights of the parties." Be that as it may, in the case at bar, the Nevada decree having declared that the agreement was "entitled to be approved," that included the provision that its "covenants" should "survive" as well as any of its other stipulations. Thus the payments made under it were "founded" as much upon the "promise or agreement" as upon the decree; indeed, they were "founded" upon both, the parties chose to submit themselves to two sanctions—contempt under the divorce court and execution under the contract. The payments were therefore subject to the gift tax. 178 F.2d 861, 865.

I would affirm the judgment.

Internal Revenue Code of 1954

Sec. 2516. Certain Property Settlements.

Where husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within 2 years thereafter (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property pursuant to such agreement—

(1) to either spouse in settlement of his or her marital or property rights, or

(2) to provide a reasonable allowance for the support of issue of the marriage during minority,

shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

Note

1. This provision is new in the 1954 Code. The Senate Report, recommending its enactment, states (p. 128): "Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift-tax status under present law of settlements not incorporated in the decree of divorce is uncertain." If an affectionate husband wants to be generous to his wife but not to the Treasury, will a settlement in conjunction with a Mexican divorce serve his purposes, if they proceed to ignore the divorce as invalid? In G.C.M. 25250, 47-2 C.B. 32, the Internal Revenue Service ruled that a Mexican divorce qualified as a "divorce" under §71(a)(1), *supra*, p. 174, even though it was invalid in the state of domicile, because the parties treated it as valid and did not obtain it as a device to reduce taxes. If the divorce is *bona fide*, does §2516 exempt the settlement from gift tax no matter how large it may be? Note that §2516 speaks of "transfers . . . in settlement of . . . marital or property rights." If the wife gets more than the value of these rights, is the excess a taxable gift?

When applicable, §2516 permits a transfer to be made free of gift tax even if the agreement is not approved by the divorce court. The importance of the *Harris* case is thus much reduced. But does that case control the status after 1954 of marital settlements that do not meet the requirements of §2516? Consider the following possibilities:

(a) A property settlement under an agreement, with divorce occurring 3 years

later. If the divorce court approves the settlement, is the transfer governed by the *Harris* case, or is §2516 the exclusive route to tax exemption for divorce settlements?

(b) A property settlement under an agreement that is approved by a decree of legal separation, where the parties do not obtain a divorce. Is the *Harris* case applicable?

(c) A property settlement which is neither approved by a court nor followed by divorce within two years. In 1946, before the *Harris* case was decided, the Internal Revenue Service conceded that a transfer of property by a husband to his wife, in exchange for her release of her right to support, under an agreement incident to a proceeding for divorce or legal separation, was not a taxable gift to the extent of the reasonable value of her right to support. E.T. 19, 46–2 C.B. 166.* (On the problem of valuing the right to support, see *infra*, p. 939.) The rationale for this ruling was that to the extent of the value of the wife's right to support, the transfer merely liquidates "a presently existing obligation, the satisfaction of which does not have the effect of diminishing or depleting the husband's estate to any greater extent than the payment of other existing legal obligations." If the value of the property received by the wife exceeded the value of her right to support, however, the Service took the position that the excess was taxable as a gift.

The ruling did not require that the transfer be judicially approved, and its reasoning covers cases where the parties enter into an informal separation (if the release of the right to support is enforceable), as well as legal separations and divorces. Does §2516 undermine E.T. 19? Does §2516(2) imply that in the absence of statutory exemption, a payment in liquidation of the obligation to support is a taxable gift?

(d) Transfers to minor children in excess of a "reasonable allowance" for their support or to adult children. Even though such transfers are not sheltered by §2516, do they escape the gift tax if ordered by the divorce court? See *Rosenthal* v *Commissioner*, 205 F.2d 505 (2d Cir. 1953).

(e) Prenuptial agreements. If Mr. Wemyss or Mr. Merrill had failed to perform their agreements until judgments were obtained against them by the ladies, would the satisfaction of the judgments be taxable under the *Harris* case?

2. There is no estate tax provision parallel to §2516. If any amounts are still payable to the wife under a marital settlement when the husband dies, they will be deductible as claims against the estate only if they meet the requirements of §2053(a)(3) and §2053(c)(1)(A): if "founded on a promise or agreement," the claims are not deductible unless they were "contracted bona fide and for an adequate and full consideration in money or money's worth." As the foregoing cases point out, this requirement is not satisfied if the consideration is a release of dower, curtesy, or other marital rights. §2043(b). (E.T. 19, *supra*, rules that a release of support is adequate and full consideration.) But it has been held that if a settlement agreement is approved by the divorce court, the claim is not "founded on a promise or agreement" and hence need not be contracted for full and adequate consideration. *Commissioner* v. *Maresi*, 156 F.2d 929 (2d Cir. 1946), *Commissioner* v. *Watson*, 216 F.2d 941 (2d Cir. 1954), *contra* (under California law), *Estate of Bowers* v. *Commissioner*, 23 T.C. No. 114 (1955). If it lacks judicial approval, will the wife's claim against the husband's estate be non-deductible in computing the estate tax even though, by virtue of §2516, payment of the claim during his lifetime would not have been a taxable gift?

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* E.T. 19, in conceding that the wife's release of her right to support is *pro tanto* adequate consideration for a transfer by the husband, renounced the fruits of a government victory. For the Court of Appeals for the Second Circuit had held that the right to support was a "marital right," whose relinquishment was not adequate consideration under §2043(b) of the estate tax law. Meyer's Estate v. Helvering, 110 F.2d 367, cert. den., 310 U.S. 651. Presumably it would have been equally inadequate to support an exemption from gift tax.

The wife apparently waived her right to support in the *Harris* case (10 T.C. at 743), but it does not appear whether the value of her right was taken into account in computing the amount of the gift. A footnote in the dissenting opinion states that the right to support was not involved in the case "for the transfer here sought to be taxed passed to the husband from the wife, who was under no obligation to support him." 340 U.S. at 113. But if the wife released her right to support, should its value have been treated, on the Treasury's theory, as a gift by her to him?

3. On the *Harris* case, see Pedrick, "The Gift Tax Jurisdiction of the Divorce Court," 46 *Ill. L. Rev.* 177 (1951); Note, Postmarital Settlements and the Gift Tax, 19 *U. of Chi. L. Rev.* 46 (1951); Taylor and Schwartz, "Tax Aspects of Marital Property Agreements," 7 *Tax L. Rev.* 19, 38 *ff.*

COMMISSIONER v. GREENE

U.S. Court of Appeals, Ninth Circuit, 1941
119 F.2d 283, cert. den., 314 U.S. 641 (1941)

Before GARRECHT, HANEY, and STEPHENS, Circuit Judges.

HANEY, Circuit Judge.

The Commissioner of Internal Revenue petitions us to review decisions of the Board of Tax Appeals that there were no deficiencies in the taxpayer's gift tax for the years 1936 and 1937.

Alice H. Lester and W. E. Lester were married more than forty years ago. As a result of the marriage two daughters, Carolyn and Beatrice, were born. The former is now about 47 years old, and the latter about 43. More than 30 years ago Alice H. Lester became incompetent and ever since has been and is now confined in an institution for insane persons. Prior thereto, the husband, wife and two daughters lived together as a family unit in luxury and in the manner of people of wealth. After the incompetency of the wife, the husband and two daughters lived together as a family unit until the marriage of Carolyn, and thereafter, the husband and Beatrice continued to live as a family unit until the marriage of Beatrice. Carolyn first married one Hamilton, and in 1930 married Thomas J. Loan who is now her husband. Beatrice in 1932 married one Pauli from whom she was divorced in 1938 and has since been unmarried.

The husband of Alice H. Lester died on May 29, 1933, and left an estate appraised at about $38,000 which was distributed in equal shares to the two daughters and the estate of the incompetent.

The incompetent has always been a person of large financial means. For example, the income from the principal of her estate which is in excess of $2,000,000 was· for 1932-$121,931; for 1933-$91,473.85; for 1934-$88,385.74; for 1935-$68,468.91; for 1936-$109,673.53; and for 1937-$142,614.13.

Loan has never contributed to the support of Carolyn, and Pauli has never contributed to the support of Beatrice. Both daughters were from birth accustomed to a life of ease and luxury, and neither of them was trained for any gainful occupation and neither of them was during any of said times able to engage in any gainful occupation Since the incompetency of their mother, the only means of support available to them has been the incompetent's estate. Except to the extent of their interest, if any, in the incompetent's estate, the payments received therefrom, and the distributions received from their father's estate, both daughters have been at all times since prior to June 6, 1932, poor persons unable to maintain themselves by work.

From time to time since the inception of the incompetency of the mother, the proper state court has made orders directing the payment of money from the estate to the husband and the two daughters. Prior to the calendar year 1937, such court refused to direct payments except for the maintenance and support of the father and daughters. The amounts ordered to be paid were

liberal. Such payments were apparently made pursuant to the following provisions of the California Civil Code and Probate Code, respectively:

> §206. . . . It is the duty of the father, the mother, and the children of any poor person who is unable to maintain himself by work, to maintain such person to the extent of their ability. . . .
>
> §1502. . . . Every guardian of an estate must manage it frugally and without waste, and apply the income, as far as may be necessary, to the comfortable and suitable support, maintenance and education of the ward and his family, if any. . . .

On October 19, 1937, the state court ordered that additional payments be made to the two daughters pursuant to Calif. Probate Code, §1558, as follows: ". . . On the application of the guardian or next of kin of an insane or incompetent person, the court may direct the guardian to pay and distribute surplus income, not used for the support and maintenance of the ward, or any part of such surplus income, to the next of kin whom the ward would, in the judgment of the court, have aided, if said ward had been of sound mind The granting of such allowance and the amounts and proportions thereof shall be discretionary with the court, but the court shall give consideration to the amount of surplus income available after due provision has been made for the proper support and maintenance of the ward, to the circumstances and condition of life to which the ward and said next of kin have been accustomed and to the amount which the ward would, in the judgment of the court, have allowed said next of kin, had said ward been of sound mind. . . ."

In the order the court directed that $7,500 be paid to each daughter and found: "That in the judgment of the court, due consideration being given to the amount of said surplus income, the circumstances and condition of life to which said ward and her said children have been accustomed, said ward, if she were of sound mind, would aid said children and would pay and distribute to her said children the portion of the said surplus income which is hereinafter directed to be so distributed."

The $7,500 was in addition to the amounts ordered to be paid for maintenance of the daughters.

The orders of the state court contained findings that the daughters were unable to maintain themselves by work; that the payments were necessary for the comfortable and suitable support and maintenance of the daughters as members of the ward's family; and that in the court's judgment, the incompetent would, had she been of sound mind, have aided the daughters by the payments in question. The amounts paid to the daughters were as follows.

Year	*To Carolyn*	*To Beatrice*
1932	$ 7,392.83	$ 5,000 00
1933	9,816.49	9,607.70
1934	11,000 00	11.000 00
1935	16,844.91	14,362.91
1936	21,000 00	21,000.00
1937	20,000.00	20,000.00

All such amounts were surplus income not used for the support and maintenance of the incompetent.

The commissioner determined that the payments were gifts and assessed

deficiencies in the gift taxes for 1936 and 1937. Respondent petitioned the Board for a redetermination of the deficiencies. The Board entered decisions that there were no deficiencies, and the Commissioner seeks review of those decisions.

Section 501 of the Revenue Act of 1932 [§2501(a), 1954 Code] provides in part: "(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual . . . of property by gift."

Section 503 [§2512(b), 1954 Code] provides. "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

A majority of the Board held that all payments made to the daughters for maintenance and support were in satisfaction of an obligation imposed by law (Calif. Civil Code §206, Calif. Probate Code §1502) and were therefore not to be classed as gifts; that the $7,500 payments in 1937 were taxable as gifts. One member of the Board dissented without opinion. Three members dissented on the ground that under §503 of the Revenue Act of 1932, all payments were gifts. Two members dissented on the ground that §206, Calif. Civil Code only required the parent to supply reasonable necessities, and that the maintenance supplied was "beyond ordinary necessities."

Respondent's argument is that Calif. Probate Code, §1502, and Calif. Civil Code, §206, impose obligations upon the incompetent's estate to support the daughters; that the state court's orders were binding on that question; and that the payments were made without donative intent and were not, therefore, gifts. Respondent's argument is based on the theory that state law is applicable. The first question to be decided is whether the state law is applicable.

The rule is that "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." *Burnet* v. *Harmel*, 287 U.S. 103, 110, . . .

Since the argument of this case, *United States* v. *Pelzer*, 312 U.S. 399 [*infra*, p. 953], was decided. That case considered §504(b) of the act in question [§2503(b), 1954 Code], which provides for an exclusion of $5,000 in "the case of gifts [other than of future interests in property]." In the last cited case the taxpayer argued that since the statute did not define "future interests" they must be taken to be future interests as defined by the local law. The court said: ". . . But as we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence, their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. . . ."

Here, property, *i.e.*, money, was transferred, and pursuant to §503, the amount of the gift is "the amount by which the value of the property exceeded the value of the consideration." The only thing in question here is the "consideration." Nothing in the act expressly states that the existence of consideration is to be determined by state law. There is no more reason for saying here that Congress

meant consideration as defined by state law, than there was for saying the Congress meant "future interests" as defined by state law.

The committee reports state that the tax imposed by the act "is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth . . ." See Committee Reports on the Revenue Acts, Cum. Bull. 1939-1 (Part 2), pp. 478, 526 [*supra*, p. 913]. Art. 1 of Treasury Regulations 79, promulgated under the act in question provides that the "tax is not limited in its imposition to transfers of property without a valuable consideration, which at common law are treated as gifts. . . ." Art. 8 of such regulations provides in part: "Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts. . . . A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

It is thus apparent that there is nothing to indicate that local law was to determine what might be consideration, but on the contrary, the taxing act considered certain transfers as gifts, whether local law so considered them or not. Since local law is not controlling, it is immaterial what local statutes said, or local courts held. . . .

Respondent's contention that there was no donative intention is immaterial, because §503 of the act in question does not require it.

The Board's decisions are reversed and the cause is remanded to the Board for further proceedings in accordance with the views herein expressed.

STEPHENS, Circuit Judge.

I dissent.

The majority opinion holds that all moneys paid out of the incompetent's estate for the support of her adult married daughters are "gifts" and taxable as such, and holds as immaterial the legal fact that the California Code imposed a legal duty upon her to support her indigent children. This is based upon the theory that "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law," citing the recent case of *United States* v. *Pelzer*, 312 U.S. 399.

I do not read the *Pelzer* case as authority for the proposition that we are not bound by the State law in the instant case. There the question involved was whether or not the gift under consideration was a gift of a "future interest." It was argued by the taxpayer that the Federal courts were bound by the State law defining what constituted a "future interest." The Supreme Court looked to the committee reports and determined that the purpose of the statute was to make taxable gifts "whether vested or contingent, limited to commence in possession or enjoyment at a future date," and that this was what was meant by the words "future interest" in the taxing statute. The Regulations had defined "future interest" in the same terms. The Court merely held that the provisions of the taxing statute were not subject to state control in this respect.

In the instant case the committee reports state that the tax imposed by the Act "is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth. . . ." The

Regulations promulgated under the Act provide that the tax shall apply to transfers without consideration, and that "a consideration not reducible to a money value, as love and affection, promise of marriage, *etc*., is to be wholly disregarded."

But this is not to say that a transfer in discharge of a legal obligation imposed by local law is a transfer without consideration under the taxing act. It is my opinion that the discharge of a legal obligation is clearly "consideration" within the meaning of the tax act, and that the statute by necessary implication makes its own operation in that respect dependent upon State law.

It seems clear that under California Civil Code, Section 206, and the cases construing that section, the incompetent at all times material to this controversy was subject to a legally enforceable obligation to support and maintain her daughters, who were, as pointed out by the majority, "poor persons unable to maintain themselves by work" within the meaning of the California law. Section 206 fixes the obligation as "to the extent of [her] ability." Section 1502 of the California Probate Code provides for the support of the family of an incompetent by the application of the income "as far as may be necessary, to the comfortable and suitable support, maintenance and education" of the family. The measure of the support and maintenance allowance was a matter for the discretion of the California Superior Court, sitting in probate, and its determination that the amounts distributed to the incompetent's daughters were necessary for their comfortable and suitable maintenance is binding upon us.

The decision of the Board should be affirmed.

Note

1. See Note, 41 *Col. L. Rev.* 1274 (1941). E.T. 19, referred to *supra*, p. 934, was based on the assumption that there is no gift tax on supporting one's family. Does the *Greene* case hold to the contrary? Does the head of a family make a taxable gift if he buys a mink coat for his wife or a Jaguar for his son? If he allows an adult child to live in his home or to use his car or yacht without charge? Under E.T. 19, it was necessary to allocate part of a lump sum divorce or separation settlement to the wife's right to support; only the balance was considered taxable. See also §2516(2). E.T. 19 had this to say of the principles governing such an allocation:

> The establishment of a reasonable allocation is regarded as a proper matter for administrative determination by the Bureau in the absence of a reasonable allocation or segregation by the parties. In making this determination the facts and circumstances of each case will be separately considered. Elements to be considered are the amount of the husband's annual income, the extent of his assets, also, the life expectancies of the parties and the probability of the wife's remarriage, alimony almost universally being limited to such periods. An agreement of the parties may provide for payments extending beyond the period of their joint lives. The required allocation in such a case will involve a determination of the question whether the aggregate amounts paid and payable exceed normal support rights, which ordinarily would terminate upon the death of the husband. The contingency of the wife's remarriage may be measured by actuarial standards. (46-2 C.B. at 169.)

See *Rosenthal* v. *Commissioner*, 205 F.2d 505 (2d Cir. 1953); *McDonald* v. *Commissioner*, 19 T.C. 672 (1953); Rudick, "Marriage, Divorce and Taxes," 2 *Tax L. Rev.* 123 (1947).

2. The American Law Institute's proposed Federal Income, Estate, and Gift Tax Statute (Tentative Draft No. 9) provides in §X1007(d) that no gift tax shall be imposed on: "A transfer arising out of illegal activity on the part of the transferee, such

as bribery, blackmail, extortion, embezzlement or theft." In the absence of such a provision, does a victim of theft make a taxable gift to the thief? Should Reinfeld have filed a gift tax return when he paid off Rutkin (*supra*, p. 94)? The proposed statute also excludes from gift tax the payment of tort claims. §X1007(c). Are such payments taxable under the existing law? Is it relevant that claims against the estate are deductible in computing the estate tax if they are "allowable by the laws of the jurisdiction . . . under which the estate is being administered," §2053(a)(3), and that full and adequate consideration in money or money's worth is required by §2053(c)(1)(A) only for a claim that is "founded on a promise or agreement"? See, for this provision's legislative history, Pedrick, "The Gift Tax Jurisdiction of the Divorce Court," 46 *Ill. L Rev.* 177, note 11 (1951).

3. Is there a taxable gift when property is transferred in settlement of a dispute, if the settlement is made not because the transferee's claim is valid but because the transferor wishes to avoid publicity or family discord? *Cf. Housman* v. *Commissioner*, 105 F.2d 973 (2d Cir. 1939), cert. den., 309 U.S. 656 (1940); Regs. 108, Sec. 86.8.

ESTATE OF ANDERSON v. COMMISSIONER

Tax Court of the United States, 1947
8 T.C. 706

[Gift tax deficiencies of about $870,000 were determined by the Commissioner on transfers, in the circumstances related below, by M. D. Clayton and W. L. Clayton of 18,675 shares of common stock of Anderson-Clayton Securities Corporation to executives of the Corporation. The Corporation was the successor of an unincorporated enterprise, referred to in the opinion as "association."]

ARUNDELL, Judge.

At the threshold we are met with the question of whether the sales of stock by Anderson and Clayton to the six individuals actively engaged in the Anderson-Clayton business enterprise are in any event subject to gift tax. Respondent concedes that these sales were bona fide and at arm's length; but he contends that they were not made in the ordinary course of business, that the value of the stock was greater than the value of the consideration received, and that the excess is therefore taxable as a gift under section 503 of the Revenue Act of 1932 [§2512(b), 1954 Code]. He relies primarily upon *Commissioner* v. *Wemyss*, 324 U.S. 303, for the proposition that the absence of donative intent is immaterial.

It is quite true that in *Wemyss* the Supreme Court held that Congress in section 503 had dispensed with the subjective test of donative intent and substituted the more workable external or objective test of whether the consideration for the transfer is full and adequate in money or money's worth. It must not be overlooked, however, that at the same time the Court was careful to point out that genuine business transactions — "business transactions within the meaning of ordinary speech"—are not within the scope of the gift tax. Citing Treasury Regulations 79 (1936 Ed.), Art. 8, it said that:

> . . . the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." . . . Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an adequate and full consideration in money or money's worth."

The first issue therefore reduces itself to the question of whether the sales of common stock of corporation were "made in the ordinary course of business." Petitioners contend that the sales were so made. They argue that, while donative intent may not be material in determining whether a gift has been made, the presence or absence of donative intent is an important circumstance in determining whether a sale or other disposition of property is made in the ordinary course of business. The regulations, they say, define a transfer made in the ordinary course of business as "a transaction which is bona fide, at arm's length, and free from any donative intent."

For the purposes of deciding the first issue thus raised, we shall assume that the stock had a value in excess of the consideration.

All the sales of stock were made pursuant to what was essentially a profit-sharing plan. Profit participation by the active management was a common practice in the cotton merchandising business generally. The evidence makes clear that cotton merchandising is primarily a management business and one of the most difficult and complex merchandising operations in the world, and that the success of the business is dependent, by and large, upon efficient and well trained management having long experience in all phases of cotton merchandising.

Prior to the organization of corporation, Clayton, Fleming, and Whittington held profit sharing or commission contracts with association which yielded them large annual returns and removed considerable cash from the business. When corporation was organized, its common stock was substituted for the profit sharing contracts; and that had the two-fold effect of keeping cash in the business as invested capital and compelling the executives to acquire a proprietary interest in the business. From the beginning, the common stock of corporation was designed to be held only by persons actively engaged in the Anderson-Clayton business enterprise. Clayton and Anderson were the holders of the largest equities in the business, and the real value of their large investments in preferred stock could be maintained and preserved only by a continued efficient management. In order to build up a responsible management which could continue the business in the event of the retirement or death of Anderson or Clayton, they believed it essential that the junior executives acquire proprietary interests in the business and that such proprietary interests should grow in proportion to the shifting of responsibilities from the seniors to the juniors.

And so the plan was put into operation upon the organization of corporation. All the common stockholders understood that the relative proportions of their holdings would change from time to time as responsibilities were shifted from the older to the younger executives. At the beginning of each cotton season it was customary to reexamine the management situation and the relative contributions to management on the part of the several executives and to determine what readjustments, if any, in the relative ownership of common stock should be made. All the sales of common stock here in issue, as well as other sales not in issue, were made pursuant to the agreement between corporation and all the common stockholders, all of whom were actively engaged in the business. Under that agreement a method was provided for determining annually, in accordance with a consolidated balance sheet adjusted so as to reflect the true net worth of the consolidated business enterprise, a price at which transfers of the common stock

should be made. The holders of 75 per cent of the common stock could direct any party to sell all or any part of his stock to corporation or to such person as they might designate. No party could sell or otherwise dispose of his common stock without the written consent of 75 per cent of the holders. If any party should elect to withdraw from the business, he had to sell his stock to corporation. If any party should die, his stock was to be purchased by corporation. No cash dividend could be paid on common stock so long as corporation was indebted in any sum whatever. Other provisions of the agreement are set out in our findings and need not be repeated here. It was contemplated not only that Clayton and Anderson would sell some of their common stock from time to time to their juniors, but also that as the latter should pass the peak of responsibility, they in turn would sell part of their holdings to their juniors who were taking on more responsibility. In other words, the common stock was designed not to be marketable, but to be held in direct proportion to the active participation of each stockholder in the business enterprise.

It is obvious from all these circumstances that the sales of common stock were motivated by the peculiar importance of expert and continuous management to the cotton merchandising business. They were intended to preserve or augment the value of the estates of Clayton and Anderson, as well as to relieve them of obligations to corporation. All the vendees of the stock were either at the time of the sales or shortly thereafter, managing executives in association and held qualifying shares to make them fully liable for the debts of association. Association being a modified form of partnership, the vendees were partners with Anderson and Clayton in the operating entity of the business enterprise. There was no intent on the part of Anderson and Clayton in selling the stock to confer, nor intent on the part of their vendees to receive, gratuitous benefits. Clearly, then, these transactions were not gifts in any ordinary sense of the word.

In contending that the sales of stock were not "made in the ordinary course of business," respondent's position appears to be that it was neither ordinary for Anderson and Clayton nor ordinary for business men in general to enter into transactions of the type here involved. We do not agree. On the contrary, it is apparent from the numerous occasions on which Clayton and Anderson sold common stock to their junior executives, both those in issue and others not in issue, that it was a quite customary and ordinary thing for them to do. The record also proves that profit sharing or participation among the active management was quite the ordinary and customary practice in the cotton merchandising business generally. Furthermore, from facts within the range of judicial knowledge, we know that nothing is more ordinary, as business is conducted in this country, than profit-sharing arrangements and plans for the acquisition of proprietary interests by junior executives or junior partners, often for inadequate consideration, if consideration is to be measured solely in terms of money or something reducible to a money value.

The cases of *Deputy* v. *DuPont*, 308 U.S. 488, and *Welch* v. *Helvering*, 290 U.S. 111, relied on by respondent, have little if any bearing on the problem here presented. Both cases deal with expense deductions for income tax purposes under a statute providing for the allowance of "ordinary and necessary expenses paid or

incurred . . . *in carrying on any trade or business.*" (Italics supplied.) It does not follow that considerations which are relevant in determining whether an item of expense is an "ordinary and necessary" business expense for purposes of income tax deduction are relevant in determining whether a transfer of property is made "in the ordinary course of business" for purposes of the gift tax.

The pertinent inquiry for gift tax purposes is whether the transaction is a *genuine business* transaction, as distinguished, for example, from the marital or family type of transaction involved in *Wemyss* and its companion case, *Merrill* v. *Fahs*, 324 U.S. 308. Surely it will not be said that there may not be a genuine business transaction not directly connected with the taxpayer's trade or business or even though the taxpayer be not engaged in "carrying on any trade or business," within the scope of that term as limited by *Higgins* v. *Commissioner*, 312 U.S. 212. Bad bargains, sales for less than market, sales for less than adequate consideration in money or money's worth are made every day in the business world, for one reason or another, but no one would think for a moment that any gift is involved, even in the broadest possible sense of the term "gift."

It appears that this is the first attempt on the part of the respondent to apply the gift tax to transactions such as those presented here. To sustain the attempt, in our judgment, would be to work a perversion of the whole purpose and spirit of the gift tax law. However broadly Congress may have used the term "gifts" in the gift tax law, and however much it may have dispensed with common law concepts of gifts, we are certain that the law was neither designed nor intended in its operation to hamper or straight-jacket the ordinary conduct of business.

We have found that the sales of stock in issue were bona fide and made at arm's length, in the ordinary course of business. Therefore, assuming, without deciding, that the value of the stock was greater than the value of the consideration, we hold that the transfers are not subject to gift tax. This makes it unnecessary to decide the question of value or to determine in which calendar years certain of the transfers were effected, and we have accordingly made no findings of fact with respect to these questions.

Reviewed by the Court.

Decisions will be entered for the petitioners.

Note

1. The cancellation of indebtedness by creditors of a business corporation was held to be a "gift" (and hence excluded from the debtor corporation's gross income by what is now §102(a) of the Internal Revenue Code) in *Helvering* v. *American Dental Co.*, 318 U.S. 322, 331 (1943): "The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the [income tax] statute." Is a gift tax due? Warren and Sugerman, "Cancellation of Indebtedness and Its Tax Consequences: I," 40 *Col. L. Rev.* 1326, 1361-1372 (1940). The *American Dental Co.* case was severely limited by *Commissioner* v. *Jacobson, supra,* p.116.

2. Does a preferred stockholder, by waiving his claim to dividend arrears, make a gift to the corporation or the common stockholders? See *Collins* v. *Commissioner*, 1 T.C. 605 (1943) (compromised, 1945 P–H Fed. Tax. Serv. ¶71,025); *cf. Wallerstein* v. *Commissioner*, 2 T.C. 542 (1943).

LOCKARD v. COMMISSIONER

U.S. Court of Appeals, First Circuit, 1948
166 F.2d 409

Before MAGRUDER, MAHONEY and WOODBURY, Circuit Judges.

MAGRUDER, Circuit Judge.

Barbara M. Lockard petitions for review of a decision of the Tax Court of the United States determining that "there is a deficiency in gift tax of $5,517.39 for the year 1941." 7 T.C. 1151.

Petitioner undoubtedly made a taxable gift in 1941. In her return she claimed the full $40,000 specific exemption. [1939] Internal Revenue Code, §1004.* The Commissioner disallowed this exemption to the extent of $22,595.95 on the ground that petitioner had claimed and been allowed an exemption of $19,363.93 in respect of a taxable gift made in 1938 and an exemption of $3,232.02 in respect of a taxable gift made in 1939. Petitioner now contends that she erroneously reported taxable gifts in 1938 and 1939, and therefore that no part of the specific exemption was properly consumed in either year. It is conceded by the Commissioner that the amounts which were claimed as exemptions in 1938 and 1939 were "allowed" within the meaning of I.R.C. §1004(a)(1) [§2521, 1954 Code]—and thus pro tanto exhausted the $40,000 specific exemption — only if the taxpayer made taxable gifts in those years. *Kathrine Schuhmacher* v. *Commissioner*, 8 T.C. 453, 464 (1947); *Carl J. Schmidlapp* v. *Commissioner*, 1941, 43 B.T.A. 829. On this branch of the case the question is whether the beneficiary's irrevocable right to receive the income from the corpus of a short term trust constitutes a taxable gift in the year in which the property is transferred to the trust, notwithstanding the fact that the settlor may remain taxable on such income under the doctrine of *Helvering* v. *Clifford*, 1940, 309 U.S. 331 †. . . .

On March 30, 1938, the petitioner created an irrevocable trust, with herself and another as cotrustees, under the terms of which the entire net income was directed to be paid to Derwood W. Lockard, her husband, for a term of six years; and upon April 1, 1944, or if the husband should die earlier, then on the date of his death, the principal was to revert to the settlor, free of trust. On March 30, 1939, the petitioner transferred additional property to the trust.

The Tax Court held that the transfers in trust in 1938 and 1939 constituted taxable gifts to Mr. Lockard, in those years, of the right to receive the income for a term of years; and therefore that the amounts of specific exemption claimed by petitioner in her gift tax returns for those two years, and allowed by the Commissioner, must be deducted from the $40,000 specific exemption claimed by her in her return of the 1941 gift. We agree with this conclusion. Valuation of these gifts in 1938 and 1939 is covered by stipulation and is not in dispute.

Section 501(b) of the Revenue Act of 1932, which is applicable to the transfers in 1938 and 1939, provides that the gift tax is applicable "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the prop-

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* The exemption is now only $30,000. §2521. [Ed.]
† *Supra*, p. 316. [Ed.]

erty is real or personal, tangible or intangible." That the broad sweep of this language was not inadvertent is emphasized in the committee reports. H.R.Rep. No. 708, 72d Cong., 1st Sess., at p. 27, stated "The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; the term 'property' reaching every species of right or interest protected by law and having an exchangeable value." See to the same effect Sen.Rep. No. 665, 72d Cong., 1st Sess., p. 39. See also *Smith* v. *Shaughnessy*, 1943, 318 U.S. 176, 180, in which the court states that the amplitude of legislative purpose, thus expressed, "is broad enough to include property, however conceptual or contingent."

By the transfer in trust in 1938, Mr. Lockard acquired an equitable right to the income from the property for a period of six years, subject only to his earlier death. He then received a legally protected interest "having an exchangeable value"; and the commuted value of this right of future income is readily calculable. *Helvering* v. *McCormack*, 2 Cir., 1943, 135 F.2d 294, 296. See art. 19(7) of Regulations 79 (1936 Ed.). To the extent of this interest, the settlor abandoned control of the property upon its transfer in trust. Not only did the settlor reserve no power to revoke, and revest in herself, the beneficial interest thus donated; she could not even modify the donee's interest or shift the benefit, in whole or in part, to another. The transfer, therefore, meets every test of taxability under the language of the Act and under the criteria laid down in *Smith* v. *Shaughnessy*, *supra*. The same may be said of the additional transfer to the trust made in 1939.

The foregoing conclusion would have seemed inevitable and inescapable if one had never heard of *Helvering* v. *Clifford*, 1940, 309 U.S. 331, a case involving income tax liability. It is recited in the stipulation in the case at bar that the distributable trust income for the years 1938-1941, inclusive, was included by the Commissioner in the income of Mrs. Lockard under I.R.C. §22(a), as interpreted in the *Clifford* case. Exegesis of *Helvering* v. *Clifford* has proceeded apace, and not without difficulty, in a large volume of subsequent litigation in the lower federal courts. See *United States* v. *Morss*, 1 Cir., 1947, 159 F.2d 142. No doubt there would be many judicial sighs if the great body of Clifford learning had to be imported into gift tax litigation. But as this court held in *Commissioner* v. *Prouty*, 1 Cir., 1940, 115 F.2d 331, 337, "the gift tax does not seem to be so closely integrated with the income tax that decisions like the *Clifford* case extending the applicability of Section 22(a) to the grantor of a trust, must necessarily be read as holding that no gift tax was payable upon the creation of the trust." [1] We tried to point out again, at considerable length, in *Higgins* v. *Commissioner*, 1 Cir., 1942, 129 F.2d 237, certiorari denied 1942, 317 U.S. 658, that under existing provisions of law respecting income, gift and estate taxes, it is quite impossible for the courts to achieve a complete integration of these three taxes. Chief Justice Stone made an apparent effort in *Estate of Sanford* v. *Commissioner*, 1939, 308 U.S. 39, to bring about a measure of correlation between the gift tax and the estate tax, by his statement, page 44 of 308 U.S., that the test of completeness of a transfer for purposes of the gift tax is no different "from that to be applied in

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[1] In fact, in the *Clifford* case itself, in which the income of a particular short term trust was held taxable to the settlor-trustee, the Court noted (309 U.S at page 333) that the settlor had paid a federal gift tax upon the transfer in trust.

determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death." *Cf. Higgins* v. *Commissioner, supra,* 1 Cir., 129 F.2d at page 240–242. But in *Smith* v. *Shaughnessy,* 1943, 318 U.S. 176, the Supreme Court disavowed any intention to intimate in the *Sanford* case that there was "a general policy against allowing the same property to be taxed both as an estate and as a gift," page 178 of 318 U.S.; and pointed out that the plan of Congress for integrating the estate and gift taxes is to be found in the provision of law granting a credit on estate taxes by reason of previous payment of gift taxes on the same property*—a "system of secured payment on gifts which will later be subject to the estate tax," page 179 of 318 U.S. Aside from this, it seems that for the most part any correlation that may exist between the three taxes is "purely coincidental."

Petitioner does not contend that there is a complete integration between the income tax and gift tax, so that the mere fact that a transfer leaves the transferor still liable to income tax on the property always negatives a gift tax liability, but she does argue that the same question of fact underlies both liability for income tax under the *Clifford* rule, and liability for gift tax — namely, whether the settlor, after the transfer in trust, remains in substance the owner of the corpus. If, notwithstanding the transfer, the settlor is deemed to remain in substance the owner of the corpus, the income therefrom — the fruit of the tree — is, for income tax purposes, attributable to the settlor, and the settlor does not escape an income tax thereon "by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefits of the income on which the tax is laid." *Harrison* v. *Schaffner,* 1941, 312 U.S. 579, 582. See *Commissioner* v. *Bateman,* 1 Cir., 1942, 127 F.2d 266, 271–274. Petitioner argues from this that, for income tax purposes, the result is the same as if the settlor of the short term trust had continued to receive the income yearly and had made a series of assignments of such income. It is contended, further, that similar treatment for gift tax purposes is appropriate, so that no gift tax should be payable when the trust is created, but actual payments of income to the beneficiary should be taxable as gifts when such payments are made from year to year.† This suggested mode of treatment may be appropriate and reasonable; the only trouble with it is that it is not sanctioned by the statutory scheme. As we have already pointed out, the income tax and gift tax each has its own independent criteria of taxability. In the trust now before us it may be true, under *Helvering* v. *Clifford,* that for income tax purposes the result is the same as if Mrs. Lockard had herself received the income each year and had made a series of assignments of it to her husband. But the fact is that she did not receive the income and then give it away by successive assignments. Upon creating the trust she made a single transfer whereby her husband then and there acquired an irrevocable right to the income for a period of years. Under the plain language of the gift tax, and under the authorities above cited, this intangible right to future income must be valued as

* *Infra,* p. 1230. [Ed.]

† This is the way the income of a revocable trust is treated See the last paragraph of Burnet v. Guggenheim, *supra,* p. 917; Commissioner v. Warner, 127 F 2d 913 (9th Cir. 1942). [Ed.]

of the date of the transfer in trust, and taxed to the donor. Accord, 2 Paul, *Federal Estate and Gift Taxation* §17.17 (1942). . . .

A judgment will be entered affirming the decision of the Tax Court.

Note

1. In *Strong* v. *Commissioner*, 7 T.C. 953 (1946), it was held that the creation of a family partnership was not a taxable gift. In an earlier income tax proceeding, the Tax Court had refused to give tax effect to the partnership on the ground that certain purported transfers of business interests were not "valid gifts." When gift tax liability was asserted, the Tax Court held that the principle of *res judicata* was applicable: "In other words, the Commissioner, having secured a holding in the prior cases that there were no completed gifts made by the transaction of October 1, 1940, can not now be heard to say, in a proceeding involving the same parties, that there were valid completed gifts made in those transactions." 7 T.C. at 957. (On the use of *res judicata* in tax cases, see *supra*, pp. 849–54.) One judge dissented and three others thought the doctrine of *res judicata* was not applicable, but concurred on the ground that in fact no gifts had been made.

2. See *Commissioner* v. *Beck's Estate*, 129 F.2d 243 (2d Cir. 1942), holding the grantor of a trust liable for a gift tax on the entire value of the corpus, although the income was to be used to pay the premiums on insurance on his life and would therefore be taxable to him under §677(a)(3) (*supra*, p. 315). After citing several other cases in which a lack of coordination among the federal income, estate, and gift taxes was recognized, Judge Frank said:

> At the bottom of [taxpayers'] contentions is this implied assumption The same transaction cannot be a completed gift for one purpose and an incomplete gift for another. Of course, that is not true, as the cases above cited make clear. Perhaps to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a "gift" in the gift tax law, a "gaft" in the income tax law, and a "geft" in the estate tax law.

See also the *Farid-Es-Sultaneh* case, *supra*, p. 108; *Galt* v. *Commissioner*, 216 F.2d 41 (7th Cir. 1954).

Does §704(e), relating to family partnerships and enacted after the *Strong* case, *supra*, was decided, adopt the gift tax conception of a completed transfer in determining the validity of a family partnership under the income tax? *Supra*, pp 348–51.

3. In *Stone* v. *Stone*, 319 Mich. 194, 29 N.W.2d 271 (1947), the plaintiffs sued successfully to set aside transfers of partnership assets to their children on the ground of mutual mistake, after the Commissioner decided that the partnership would not be recognized for income tax purposes. Could the transferors then recover any gift taxes paid on the conveyances? *Supra*, pp.918-9, *Board* v. *Commissioner*, 14 T.C. 322 (1950); see also *Lowry* v. *Kavanagh*, 322 Mich. 532, 34 N.W.2d 60 (1948).

COMMISSIONER v. HOGLE

U. S. Court of Appeals, Tenth Circuit, 1947
165 F.2d 352

Before PHILLIPS, BRATTON, and HUXMAN, Circuit Judges.

PHILLIPS, Circuit Judge.

The Commissioner assessed gift taxes against Hogle for the years 1936 to 1941, inclusive. On review, the Tax Court held there were no deficiencies in gift taxes for those years.

The question presented is whether or not annual earnings of two trusts, one

known as the Copley Trust, and one known as the Three Trust, during the years in question, from trading in securities and commodities carried on by the trusts under Hogle's direction, amounted to gifts by Hogle to the trusts. These trusts were before this court in *Hogle* v. *Commissioner*, 10 Cir., 132 F.2d 66, and the facts with respect to such trusts are there fully set out.

The Copley Trust was created in 1922 by Hogle and his wife for the benefit of their three children. It consisted of a securities trading account to be managed and operated under Hogle's direction, the property accruing to the trust to be divided among the children on April 15, 1945. The trust was irrevocable and Hogle retained no right to alter or amend the trust instrument, or to change the beneficial interests. None of the principal or income could revest in Hogle. It provided that any losses resulting from trading in excess of the "profits and various income returns thereof" should be made good by Hogle, and that any such losses should not become an indebtedness of the trustee or the beneficiaries, but that any such losses made good by Hogle should be returned to him out of the first profits that accrued from further transactions.

On October 7, 1922, a margin account was opened for the trust with J. A. Hogle & Company, a brokerage partnership, consisting of Hogle and his wife, and in which the three children subsequently became partners. The trading resulted in profits in every year, except 1928 and 1929. In those years, certain securities were given to the trust by Hogle and his wife. The profits and benefits in the trust were divided on April 15, 1945, among the three children, and the trust was terminated.

In 1932, Hogle opened a trading account with the partnership in the name of the Three Trust account and a few days thereafter, Hogle and his wife created the Three Trust, consisting of a securities trading account for the benefit of the three children. The trust was irrevocable and was in all respects like the Copley Trust, with the exception it was to terminate on April 15, 1950, and income could be distributed in the meantime in the discretion of Hogle and any two of the three trustees. Although the trading was conducted in the name of the trust, receipts and disbursements were credited and debited to the individual beneficiaries according to the specified share of each during the term of the trust. Gains and profits were realized in every year, including the taxable years.

The net worth of each trust in each of the years for which the gift taxes were assessed was more than sufficient to provide the margins required to cover the trading carried on for it.

In *Hogle* v. *Commissioner*, *supra*, we held, under the doctrine of *Helvering* v. *Clifford*, 309 U.S. 331, that the net income resulting from trading on margin was taxable to Hogle. We do not think it follows, however, that the net income in each of the taxable years derived from trading constituted a gift thereof by Hogle to the trusts.

Section 501 of the Revenue Act of 1932 imposed a tax upon the transfer, during the calendar year, of property by gift. Section 1000 of the [1939] Internal Revenue Code [§2501(a), 1954 Code] contains a substantially identical provision and it applies to the calendar year 1940 and subsequent calendar years. And Article 2, Treasury Regulations 79, provides among other things that a gift tax is imposed whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible;

and further, that the tax applies to all transactions whereby property or property rights or interests are donatively passed or conferred upon another. The purpose of the statute is to reach and lay a tax upon every type and kind of transfer of property by gift. With that legislative purpose in mind, the terms "property," "transfer," "gift," and "indirectly," as used in the statute, should be interpreted in their broadest and most comprehensive sense. But the tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift.

The net income derived from trading carried on in behalf of the trusts accrued immediately and directly to the trusts, and did not consist of income accruing to Hogle which he transferred by anticipatory gift to the trusts. Hogle never owned or held an economic interest in such income. Likewise, since the funds in the trusts were sufficient to provide the margins required to cover the trading carried on in the taxable years, any losses resulting from trading would have been suffered immediately and directly by the trusts. What, in fact and in reality, Hogle gave to the trusts in the taxable years was his expert services in carrying on the trading, personal services in the management of the trusts. Hogle could give or withhold his personal services in carrying on trading on margin for the trusts. He could not withhold from the trusts any of the income accruing from trading on margin. How could he give what he could not withhold? There was no transfer directly or indirectly from Hogle to the trusts of title to, or other economic interest in, the income, from trading on margin, having the quality of a gift. In short there was no transfer directly or indirectly by Hogle to the trusts of property or property rights.

The Commissioner places strong reliance upon *Hogle* v. *Commissioner, supra,* to sustain the contention that the income arising from the trading on margin represented personal earnings of Hogle; and that Hogle in substance gave to the trusts the profits derived from part of his individual efforts. Certain excerpts from the opinion are emphasized in support of the argument that the net income arising from the trading on margin for the benefit of the trusts represented earnings of Hogle, and that, upon the accrual of such income to the trusts, a transfer having the quality of a gift was effectuated within the meaning of §§501 and 1000, *supra.* But, we think a critical reading of the opinion in that case in its entirety will indicate that it does not support the Commissioner's contention. While the court drew a distinction between the income tax liability of Hogle on profits accruing to the trusts from trading on margin and gains accruing to the trusts from other sources, and held that he was liable for the tax on net income derived from such trading but not on gains accruing from other sources, his liability for tax on the net income derived from trading on margin was predicated upon his power to control indirectly the extent of the profit derived from such trading by determining the extent and amount of such trading. Despite certain statements contained in the opinion on which the Commissioner relies, the basis of the holding that Hogle was liable for income tax on the net income resulting from trading on margin was his power to control the extent of such trading and therefore the extent of the income therefrom. It was predicated on his power to dominate the amount of income that would accrue from trading. That was the essence of our holding. We did not hold that such income accrued first to Hogle and was by him transferred by anticipatory gift to the trusts.

Our holding in *Hogle* v. *Commissioner*, *supra*, was an extreme application of the doctrine of the *Clifford* case, *supra*. To hold that the profits accruing from trading in margins constitute gifts from Hogle to the trusts, we think, would be an unjustified extension of the doctrine of the *Clifford* case.

Affirmed.

HUXMAN, Circuit Judge, concurs in the result.

Section C. The Gift Tax Exclusion

HELVERING v. HUTCHINGS

Supreme Court of the United States, 1941
312 U.S. 393

MR. JUSTICE STONE delivered the opinion of the Court.

The petition for certiorari presents the single question whether under §504(b) of the Revenue Act of 1932, the donor of property in trust for the benefit of numerous beneficiaries is entitled to a single gift tax exemption or exclusion to the extent of the first $5,000 or to separate exemptions of $5,000 for each beneficiary.*

Sections 501(a), 502(1) impose for each calendar year a tax on the net amount of the transfers "by any individual . . . of property by gift." By §501(b) the tax applies "whether the transfer is in trust or otherwise" and "whether the gift is direct or indirect." In the computation of the tax laid upon "net gifts" made during the calendar year, §504(b) provides "In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts . . . shall not . . . be included in the total amount of gifts made during such year." And §1111 [§7701(a)(1), 1954 Code], defining generally terms used throughout the Revenue Act, provides: "(a) When used in this Act—(1) The term 'person' means an individual, a trust or estate, a partnership, or a corporation."

On December 30, 1935, the taxpayer executed a trust indenture by which she transferred, in trust, property of a value of approximately $145,000 for a term ending in 1947, unless sooner terminated by the trustees, for the benefit of her seven children, with gifts over of the share of each child in event of the death of that child before the expiration of the trust. The taxpayer in her gift tax return for 1935 excluded from the taxable amount of her gifts the sum of $5,000 for each child or a total of $35,000. The Commissioner allowed only a single deduction of $5,000 in lieu of the seven $5,000 deductions claimed by the taxpayer and assessed a deficiency accordingly. The Board of Tax Appeals, treating the trust as the donee rather than the individual beneficiaries, sustained the Commissioner's assessment. The Court of Appeals for the Fifth Circuit reversed. 111 F.2d 229. We granted certiorari, 311 U.S. 638, to resolve a conflict of the decision below and of like decisions in other circuits, *Welch* v. *Davidson*, 102

* The exclusion is now provided for by §2503(b), but the amount, *supra*, p. 908, is now only $3,000. [Ed.]

F.2d 100 (first circuit); *Rheinstrom* v. *Commissioner*, 105 F.2d 642 (eighth circuit); *McBrier* v. *Commissioner*, 108 F.2d 967 (third circuit), and in the Court of Claims, *Pelzer* v. *United States*, 90 Ct. Cls. 614; 31 F.Supp. 770, with that of the Seventh Circuit in *United States* v. *Ryerson*, 114 F.2d 150.

It is not doubted that separate gifts, other than of future interests, made directly to the donees without the intervention of a trustee entitle the donor under §504(b), to one $5,000 exclusion for each gift. But the Government argues that here the trustee or the trust is the donee and as there was only a single trust there can be only a single statutory deduction from the total amount of the gifts. As the statute allows one deduction of the first $5,000 for each gift "made to any person" by the donor, the question for decision is whether in this case of a gift in trust for the benefit of the designated beneficiaries the single trust, or each beneficiary, is the "person" to whom the gift was made and for which the deduction is allowed.

The statutory definition of "person" in §1111(a)(1) is of little aid in answering this question. The definition is made generally applicable to all of the sections of the revenue act and was carried forward from earlier acts which contained no gift tax provisions. See §2(a)(1) of the 1926 Revenue Act, 44 Stat. 9; §701(a)(1) of the 1928 Revenue Act, 45 Stat. 878. The section means no more than the word "person" in any section of the act in which it occurs may be taken as meaning "trust" rather than "individual" as the context may require. But §504(b), allowing the deduction in the case of each gift to any person when applied to gifts in trust for designated beneficiaries, may be read as referring either to a gift to the trust or a gift to each individual beneficiary. Hence we must read the section in its setting of the gift tax provisions and in the light of its legislative history, to determine whether, within its meaning, the trust or each individual beneficiary is the donee to whom the gift is made.

The gift tax provisions are not concerned with mere transfers of legal title to the trustee without surrender by the donor of the economic benefits of ownership and his control over them. A gift to a trustee reserving to the donor the economic benefit of the trust or the power of its disposition, involves no taxable gift. It is only upon the surrender by the donor of the benefit or power reserved to himself that a taxable gift occurs, *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, *Rasquin* v. *Humphreys*, 308 U.S. 54, and it would seem to follow that the beneficiary of the trust to whose benefit the surrender inures, whether made at the time the trust is created or later, is the "person" or "individual" to whom the gift is made.

But for present purposes it is of more importance that in common understanding and in the common use of language a gift is made to him upon whom the donor bestows the benefit of his donation. One does not speak of making a gift to a trust rather than to his children who are its beneficiaries. The reports of the committees of Congress used words in their natural sense and in the sense in which we must take it they were intended to be used in §504(b) when, in discussing §501, they spoke of the beneficiary of a gift upon trust as the person to whom the gift is made. Similarly they spoke of gifts effected by transfer of money or property to another as consideration for the payment of money or other property to a third person as a gift to the third person. H. Rept. No. 708, 72d Cong., 1st Sess., pp.27–28; S. Rep. No. 665, 72d Cong., 1st Sess., pp.39–40. It is of some

significance also that the denial by §504(b) of the exemption in the case of gifts of "future interests" has little scope for practical operation unless the gifts to which the exemption applies include those gifts made to beneficiaries of a trust, since it is by resort to the conveyance in trust that most future interests are created.

Moreover, the very purpose of allowing a gift tax exemption measured by the number of donees would be defeated if a distinction were to be taken between gifts made directly to numerous donees and a gift made for their benefit by way of a single trust, and we are unable to discern in the statute or its legislative history any purpose to make such a distinction. While one object of the exemption was to permit small tax free gifts, and at the same time "to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts" without the necessity of keeping accounts and reporting the gifts, H. Rept. *supra*, 29; S. Rept. *supra*, 41, nevertheless the statute extended the exemption in the specified amount to all gifts, whether large or small, "made to any person."

In the face of an exemption thus made broadly applicable to all gifts to all donees and in the absence of some indication of an intention to discriminate between gifts made directly to the donees and those made indirectly to the beneficiaries of a trust, we can hardly assume a purpose to favor one class of donees over the other or find such a purpose in the words of the statutory definition of "person" which may indicate either the trust or each individual beneficiary of the trust as the person to whom the gift is made. Further, such an assumption would open the way to avoid the $5,000 limitation upon the allowed exemption, by resort to the simple expedient of the creation by a single donor of any number of trusts of $5,000 each for the benefit of a single beneficiary.[1] A construction so dependent upon an artificial meaning of the words of the statute and so out of harmony with the statutory scheme and purpose is not to be favored.

Article 11 of 79 Treasury Regulations (1933 edition), issued under the 1932 Act, treats each gift to the beneficiary of a trust as entitled to the benefit of the $5,000 deduction unless the gift is of a "future interest" which §504(b) excepts from the exemption otherwise allowed. Such we think is the correct construction of the statute.

It is unnecessary to consider here the question whether a gift upon a trust for impersonal, public or charitable purposes where there are no designated or ascertainable first beneficiaries is a gift to the trust entitled to a single $5,000 deduction. See *Hutchings* v. *Commissioner*, 111 F.2d 229, 231. Nor do we consider whether the gifts to the beneficiaries here are of future interests which are excepted from the benefit of the $5,000 deduction allowed by §504(b). That question is not presented by the petition for certiorari. But our judgment will be without prejudice to consideration of that question by the Board of Tax Appeals upon the remand to it if, under the rules and procedure governing proceedings before the Board, the Commissioner is free to present the question there.

Affirmed.

[1] It was this construction of the statute by the Board of Tax Appeals and by "several of the federal courts" which led to the amendment of §504(b) so as to withdraw the exemption in the case of every gift in trust. See § 505 of the 1938 Act, 52 Stat. 447. S. Rept. No. 1567, 75th Cong., 3rd Sess., p. 41.

Note

1. The exclusion, originally $5,000, was reduced to $4,000 for gifts during the years 1939–1942 and to $3,000 for gifts after 1942. As pointed out in the Court's footnote on page 952, the exclusion was denied to gifts in trust by the 1938 Act. As a consequence of the *Hutchings* case, however, Congress in 1942 restored the annual exclusion for subsequent gifts in trust.

2. If *A* gives $12,000 to a corporation of which the stock is owned 50 per cent by him and 25 per cent by each of his two children, has he made a taxable gift? *Thompson* v. *Commissioner*, 42 B.T.A. 121 (1940), compromised, 30 A.F.T.R. 1534 (1942); *Heringer* v. *Commissioner*, 21 T.C. 607 (1954), *cf. Collins* v. *Commissioner*, 1 T.C. 605, 607, 610 (1943); Note, Federal Gift Taxation of Donative Transfers to Family Corporations, 50 *Yale L.J.* 335 (1940). What if the corporation was wholly owned by *A*? *Scanlon* v. *Commissioner*, 42 B.T.A. 997 (1940).

3. Section 2501(a) embraces transfers by gift "by an individual . . . whether the gift is direct or indirect." What of gifts by a corporation? See Regs. 108, Sec. 86.2(a)-(1), which accords with the views of the committees of Congress that recommended the enactment of the present gift tax. H. Rept. No. 708 and S. Rept. No. 665, 72d Cong., 1st Sess.; 1939–1 C.B. (Part 2) 476, 524. What if a stockholder objects to the gift?

UNITED STATES v. PELZER

Supreme Court of the United States, 1941
312 U.S. 399

MR. JUSTICE STONE delivered the opinion of the Court.

Decision in this case turns on the question whether certain gifts of property in trust for the benefit of several beneficiaries are gifts of "future interests" which, in the computation of the gift tax, are, by §504(b) of the 1932 Revenue Act [§2503(b), 1954 Code], denied the benefit, otherwise allowed, of exclusion from the computation to the extent of the first $5,000 of each gift "made to any person by the donor" during the calendar year.

Sections 501(a) and 502(1) of the 1932 Act impose for each calendar year a tax upon the net amount of transfers "by any individual . . . of property by gift." For the purpose of computing the tax §504(b) provides "In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts . . . shall not . . . be included in the total amount of gifts made during such year."

In 1932 the taxpayer, respondent here, created a trust for the benefit of his eight grandchildren and any other grandchildren who might afterward be born during the term of the trust. The trustee was directed to accumulate the income for a period of ten years and thereafter to pay an "equal grandchild's distributive share" of the income to each of the named grandchildren who were then living and twenty-one years of age and to pay a like share of income to each other named grandchild for life after that child should reach the age of twenty-one years. Provision was made whereby grandchildren born after the creation of the trust and during its life were to receive like participation in the income of the trust except as to distributions of income made prior to the birth of such after-born grandchildren, and except that the after-born grandchildren should be paid their shares of the income during their respective minorities after the termination

of the ten-year accumulation period. The trust instrument also made gifts over of the share of the income of each grandchild at death, the details of which are not now material. It was further provided that the trust should terminate twenty-one years after death of the last survivor of the named grandchildren, when the corpus of the trust, with accumulated income, was to be distributed in equal shares among the surviving grandchildren and the issue *per stirpes* of all deceased grandchildren.

During the years 1933, 1934, and 1935, the taxpayer added further amounts of property to the 1932 trust. In 1934 he also made gifts directly to his three granddaughters and created a trust to pay the income in equal shares to his wife and three daughters with gifts over of each share of the corpus of the trust upon the death of the life tenant.

Upon claims for refunds of overpaid taxes upon the transfers made in the years 1933, 1934, and 1935, the commissioner recomputed the tax and allowed one $5,000 exclusion only from the net amounts subject to gift tax given or added in each year to each trust. In the present suit, brought in the Court of Claims, respondent sought to recover overpaid taxes for the years in question on the grounds that the gifts to the beneficiaries were gifts of present, not future, interests and that the taxpayer in the computation of the tax for each year was entitled to one exclusion of $5,000 for each beneficiary. The court sustained both contentions and gave judgment for respondent accordingly. 90 Ct.Cls. 614, 31 F.Supp. 770. We granted certiorari, 311 U.S. 634, to resolve the conflict of the decision below with that of the Seventh Circuit in *United States* v. *Ryerson*, 114 F.2d 150.

The Government challenges both grounds of decision below. It argues that only a single $5,000 exclusion is allowable under §504(b) from the total gifts made to the trust in each calendar year and that if the gifts are deemed to be made to the named beneficiaries of the trust no deduction can be allowed in the case of gifts to the 1932 trust because they were of future interests for which no exclusion is allowed by §504(b).

We have this day decided the first question, in *Helvering* v. *Hutchings*, *ante*, p. 393, in which we held that in the case of gifts in trust the beneficiaries are the persons to whom the gifts are made and that for purposes of computation of the tax §504(b) excludes the first $5,000 in value of the gift to each beneficiary from the taxable amount of the gifts made in the calendar year For the reasons stated in our opinion in that case we hold that the first beneficiaries of the trusts in this case are the persons to whom the gifts were made and that the taxpayer is entitled to the benefit of the $5,000 exclusion for each gift to such beneficiary if it is not of a future interest.

But the Government argues here, as it did below, that the gifts to the beneficiaries of the 1932 trust are of future interests within the meaning of the statute and treasury regulations While the eight named grandchildren are the first beneficiaries of the trust, and the persons to whom the gifts were made, none of them takes any benefit from the trust before the end of the ten-year accumulation period or until he is twenty-one, whichever last occurs, and then only if he survives that event. And the question is whether such a gift is a gift of a "future interest" within the meaning of §504(b). Respondent, relying on statutes and judicial decisions of Alabama, where the trust was created and is being ad-

ministered, insists that the gifts to the named grandchildren are present, not future, interests as defined by Alabama law. He argues that as §504(b) does not define the "future interests" gifts of which are excluded from its benefits, they must be taken to be future interests as defined by the local law, and it is the local law definition of future interests which must be adopted in applying the section. But as we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. *Burnet* v. *Harmel,* 287 U.S. 103, 110; *Morgan* v. *Commissioner,* 309 U.S. 78, 81.

We find no such implication in the exclusion of gifts of "future interests" from the benefits given by §504(b). In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command. The committee reports recommending the legislation declared (H. Rept. No. 708, 72d Cong., 1st Sess., p. 29; S. Rept. No. 665, 72d Cong., 1st Sess., p. 41):

> The term "future interests in property" refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts.

Article XI of Treasury Regulations 79, 1933 and 1936 editions, interpreting §504(b), declared that "future interests" include any interest or estate "whether vested or contingent, limited to commence in use, possession, or enjoyment at some future date or time." This definition stands unchanged in the regulations and, while §504(b) was amended by §505 of the 1938 Revenue Act so as to withdraw the benefit of the $5,000 exclusion from all gifts in trust, the section as amended continues to withhold the benefit of the exclusion from all gifts of "future interests in property."

We think that the regulations, so far as they are applicable to the present gifts, are within the competence of the Treasury in interpreting §504(b) and effect its purpose as declared by the reports of the Congressional committees, and that the gifts to the eight beneficiaries of the 1932 trust were gifts of future interests which are excluded from the benefits of that section. Here the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survive the ten-year period they will never receive any part of either. The "use, possession, or enjoyment" of each donee is thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.

We have no occasion to consider the definition of future interests in other

aspects than those presented by the present case. The judgment of the Court of Claims will be reversed so far only as it excluded the gifts to the 1932 trust from the computation of the tax for each of the years in question.

Reversed

Note

1. What is the function of the annual exclusion of $5,000 (now $3,000) per donee? Why is the exclusion denied to gifts of "future interests"? Is there any difficulty in determining that there will be at least *one* "eventual donee" of the 1932 trust?

2. Would the exclusion have been denied in the *Pelzer* case, *supra*, if the trustee of the 1932 trust had been directed to apply such income "as may be necessary for the education, comfort and support" of the grandchildren and to accumulate only the *remainder* for ten years? *Commissioner* v. *Disston*, 325 U.S. 442 (1945); see *Commissioner* v. *Sharp*, 153 F.2d 163 (9th Cir. 1946); *McCoy* v. *Commissioner*, ¶47,272 P-H Memo TC.

3. At one time the Treasury took the position that a life estate is a future interest, except for the income to be paid to the donee in the year of the gift, because the annual installments are to be paid at future times. Several cases holding to the contrary were apparently approved by the Supreme Court in *Fondren* v. *Commissioner*, 324 U.S. 18, 21 (1945): ". . . it has been held that if the income of a trust is required to be distributed periodically, as annually, but distribution of the corpus is deferred, the gift of the income is one of a present interest, that of the corpus one *in futuro*." In *Charles* v. *Hassett*, 43 F. Supp. 432 (D. Mass. 1942), the court pointed out some of the implications of holding that a life estate is a present interest but a remainder a future interest:

> If a gift of $5,000 to trustees to pay the income to *A* for life is a present interest, what is to be said of these gifts: (1) $200 to *A* each year so long as he lives; (2) $200 to *A* the first year, if he lives, $300 to *A* the second year, if he lives, $400 to *A* the third year, if he lives, *etc.;* (3) $200 to *A* the first year, if he lives, $200 to *A* the second year, if he lives, *etc.* and $5,000 to *A* the fifteenth year, if he lives; and finally, (4) the income on $5,000 to *A* each year he lives for the next fifteen years, and then $5,000 to *A* in the fifteenth year?
>
> To the argument implied in that progression, the answer is that historically lawyers have treated gifts of income beginning at once and lasting for life, or for a period of years, as a "present interest" and gifts of principal at a future date as a "future interest"; that Congressional committees and the Treasury appear to have had some such distinction in mind; and that this and other circuits in construing the gift tax statute have used that line of distinction in cases where the gifts of income and of principal were to different persons. . . . No historical reason justifies abandoning the distinction in cases where the gifts of income and of principal are to the same person and are therefore regarded by donor and donee as one gift.

The court then pointed out the "anomalous" result that the donor may pay a heavier gift tax if he gives *A* the income of a trust until the age of 25 and the remainder at that age than if he gives *A* the income until 35 with remainder then This can be seen more clearly with an example. Suppose *A* transfers $5,000 in trust to pay the income to *B* (who is now 15 years old) until he reaches 25, with the principal to be paid to him or his estate at that time. Assuming that the $5,000 of principal will be invested at 3½ per cent so that $175 of income will be produced annually, *B*'s interest in the income is worth $1,455 and his remainder is worth $3,545.* If the trust is to continue until *B* is 35, however, his interest in the income would be worth $2,885 and his remainder $2,115. Since only the life interests are within the $3,000 exclusion, the taxable gift

* See Table II, Regs. 105, Sec. 81.10.

would be $3,545 in the case of the shorter trust but only $2,115 in the case of the longer trust. Note, however, that this odd result is produced only because the shorter trust "wastes" more of the $3,000 exclusion than the larger one. The trusts would be taxed identically if both life interests exceeded $3,000 in value. Thus if the amount involved were $15,000, there would be a taxable gift of $12,000 whether the term of the trust was 10 years or 20.

A similar paradox is exemplified by *Evans* v. *Commissioner*, 198 F.2d 435 (3d Cir. 1952), involving a trust under which the income was payable to a named beneficiary for life, with a power in the trustee in its "uncontrolled discretion" to advance principal for "the education, comfort and support" of the income beneficiary. Although the Treasury conceded that to the extent of the life interest the gift was not a gift of a future interest, it contended that the value of this part of the gift could not be determined because of the trustee's power to invade principal. The court agreed, and denied the exclusion. The decision was overruled by the second sentence of §2503(b), added in 1954.

4. See generally Cavitch, "Obtaining the Gift Tax Exclusion on Gifts in Trust: Drafting and Legislative Suggestions," 51 *Mich. L. Rev.* 621 (1953).

GILMORE v. COMMISSIONER

U.S. Court of Appeals, Sixth Circuit, 1954
213 F.2d 520

Before ALLEN and MCALLISTER, Circuit Judges, and GOURLEY, District Judge.

MCALLISTER, Circuit Judge.

The issue in this case is whether a gift of property in trust for the benefit of minors, providing that the trustees pay the principal and income to the beneficiaries upon their demand, with a further provision permitting the trustees to invest the trust funds in income or non-income producing investments, is a gift of a present interest. If such gift is one of a present interest, it is not taxable to the donor under §1003(b)(3) [§2503(b), 1954 Code]. If the gift is one of a future interest, the donor, under the circumstances of this case, is taxable. The Commissioner held that the gifts were of future interests; and the Tax Court sustained such holding in its decision, from which review is sought in this court. We are of the opinion that the decision of the Tax Court was erroneous and should be reversed.

Petitioner made the gifts, of corporate stock, by the creation of trusts for her seven minor grandchildren. The trusts provided that the trustees *"shall pay the principal and all income from the trust estate to (the named beneficiary) upon demand by the said (beneficiary),* and in case of his death this trust will terminate and all of the remaining principal and accumulated income therefrom shall be paid to the estate of the said (beneficiary)." (Emphasis supplied.)

The trust further provided that "All payments of income or distribution of principal to the beneficiary . . . shall be made to such beneficiary in person or upon his personal receipts"; that they should not be grantable, transferable, or otherwise assignable in anticipation of payment thereof, in whole or in part, by the voluntary or involuntary acts of any such beneficiary, or by operation of law, and should not be liable or taken for any obligation of such beneficiary. It was further provided that payments or distributions to an incompetent beneficiary might be made by the trustees for the benefit of such beneficiary in certain desig-

nated ways as in the opinion of the trustees would be most desirable, as noted in the margin.[1]

The Commissioner, in his determination of deficiency, denied the claimed exclusion and determined that the gifts were of future interests on the ground that "Since the beneficiaries at the time of the transfers ranged in ages from one to seven years it is considered that each of the transfers of the trust income and corpus were 'future interests' as defined by the Commissioner." The Tax Court's decision was, however, not based on the minority of the beneficiaries but upon the terms of the trust which the court construed so to limit the beneficiaries' rights, as to compel the conclusion that the gifts involved were of future interests, whether or not the beneficiaries were minors.

While the statute allows an exclusion for gifts of property other than gifts of future interests, it does not define "future interests"; but the term has the accepted meaning of an interest limited to commence in use, possession, or enjoyment, at some future date. *United States* v. *Pelzer,* 312 U.S. 399. An interest in property is a present interest if the donee has the right presently to use, possess, or enjoy it. *Fondren* v. *Commissioner,* 324 U.S. 18. The Tax Court, in the instant case, held that the provision in the trusts, that the trustees shall pay the principal and all income upon demand to the beneficiary, gave the beneficiary the right to presently use, possess, or enjoy the property, and that this provision, alone, rendered all the gifts of present interest. But the court went on to say, and to hold, that the provision giving the trustees the authority to invest the trust corpus in non-income producing property, as well as the spendthrift clause, eliminated the right of the beneficiaries to demand payment of principal and income given them in the prior provision of the trust instrument. This seems to us a non-sequitur, which controlled and vitiated the decision below.

The Tax Court considered that the provision granting to the trustees general investment powers, including the power to invest in such investments, whether producing income or not, as the trustees in their discretion should deem proper and for the best interests of the donee, resulted in making the donee's right to income contingent on the trustees' willingness to invest the corpus in such manner that income would be derived therefrom, and that such a contingent right was not a right presently to use, possess, or enjoy the property. But the trust gives the donee the absolute right to all income. The fact that there may not be income

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[1] "Payments or distributions to an incompetent beneficiary may be made by the Trustees for the benefit of such beneficiary in such of the following ways as in their opinion shall be most desirable: (a) directly to such beneficiary; (b) to the duly qualified legal representative or representatives of such beneficiary, (c) to some near relative or friend of such beneficiary; or (d) by the Trustees using payment directly for the benefit of such beneficiary. Distributions of the Trust Estate, or any share thereof, may be made in investments at the fair market value thereof and cash, or either, and in such proportions thereof as the Trustees shall deem to be most equitable

"*Incompetent Persons.* A person shall be deemed 'incompetent' for the purposes of this agreement if he or she shall be under legal disability declared or adjudicated by a court of competent jurisdiction, or if he or she shall be incapacitated to such extent as, in the Trustees' opinion, shall make it impossible or impracticable for such person to give prompt and intelligent consideration to business matters. The Trustees may require, accept and act upon such evidence of the competence or incompetence of any person as the Trustees shall deem appropriate and reliable without liability by reason thereof"

during a year is not a contingency imposed by the donor. It is the right of a donee to the income, rather than the accident of whether there is income at any given time, that is the criterion of present interest. That the corpus of a trust may consist of non-interest bearing notes, payable at a future date, does not prevent a gift from being one of present interest. *Commissioner of Internal Revenue* v. *Kempner*, 5 Cir., 126 F.2d 853. Nor does the "spendthrift" clause contained in the trust instrument do irreparable damage, as found by the Tax Court, to the contention that the gifts were of present interest. The presence of such a clause is not controlling in considering whether a gift is of a present interest, where the donee has the right at any time to demand payment to him of the corpus and income.

The Tax Court appears to have considered that the provision in the trust instrument for using payments of principal or income "directly for the benefit of such beneficiary" gave unqualified power in the discretion of the trustees, to hold the corpus and income in disregard of a direct demand for the payment thereof by a donee. Where a trust authorizes the payment by the trustees, upon demand by the beneficiary, either direct to the beneficiary, to his parent, or other person with whom he resides, or by direct application by the trustee for the benefit of the beneficiary, there is no discretion on the part of the trustee to withhold payment. And again, we come back to the unqualified direction to the trustees to pay the principal or income of the trusts *on demand of the beneficiary*. *Kieckhefer* v. *Commissioner*, 7 Cir., 189 F.2d 118, 121, is an authority in point on the issue here presented. There, the donor created a trust for the benefit of his grandson, at that time less than one month of age. The instrument provided for payment to, or application for, the benefit of the beneficiary of so much of the trust income or principal as might be necessary for the education, comfort, and support of the beneficiary, with instructions to accumulate the balance of income for future distribution. It was further provided that the beneficiary was to be entitled to all or any part of the trust estate, free of trust, whenever he, or his legally appointed guardian, made due demand therefor by an instrument in writing. The Tax Court had held that the gift of both income and principal was clearly one of a future interest, and that the right of the beneficiary to demand payment was nugatory since a minor was incapable of making an effective demand. The Court of Appeals reversed, and held the gift to be one of present interest because the beneficiary's right to demand gave him an unconditional right to the present use, possession, or enjoyment of the property. In its decision, the court held that "It is not . . . the use, possession or enjoyment by the beneficiary which marks the dividing line between a present and future interest, but it is the right conferred upon the beneficiary to such use, possession or enjoyment." It is the right given to the donee, in the trust instrument, to use, possess, or enjoy, and not the capacity of the donee, which determines whether the gift is one of present or future interest. *Fondren* v. *Commissioner*, 324 U.S. 18; *United States* v. *Pelzer*, 312 U.S. 399.

The government, however, submits that even though the beneficiaries were adults, the gifts in this case would be contingent to them for the same reason they would be contingent to the infant beneficiaries, and that no beneficiary, adult or infant, could make an effective demand that the trustees pay him the entire estate at any time—in spite of the fact that the trust instrument expressly provides for such payment on demand. We are unable to concur in such a view, so obviously

contrary to the donor's intention and so clearly contrary to the language of the trust instrument.

The Tax Court further decided that the gifts were not of present interest because the trust instrument provides that the trustees may determine, in their own discretion, whether a beneficiary is incapacitated to such an extent as to make it impossible for him to give prompt and intelligent consideration to business matters, and in such case, they were empowered to make payments at their sole discretion, among other ways, by using such payments for the benefit of the beneficiary. The Tax Court, therefore, held that the beneficiary's right to present enjoyment of income or principal was contingent on the mere whim of the trustees.

With regard to incompetence, the provision in the trust instrument is that a person shall be deemed "incompetent," for the purposes of the trust, if he shall be under legal disability, declared or adjudicated by a court of competent jurisdiction, *or if he shall be incapacitated* to such extent as, in the trustees' opinion, shall make it impossible or impracticable for him to give prompt and intelligent consideration to business matters, and that the trustees may require, accept, and act upon such evidence of the competence or incompetence of any person that the trustees shall deem appropriate and reliable. This certainly does not mean that the trustees may determine, by their mere whim, that a donee is incompetent, because incapacitated. "Incapacitated" is a strong word, and, according to the purport of the trust instrument, a conclusion by the trustees that a beneficiary is incompetent and incapacitated envisages reliance on trustworthy evidence. The discretion of the trustees in this regard is the discretion of reasonable men acting as trustees. They must act in good faith. They cannot act on arbitrary whim, and any such action could be remedied by a court of equity on grounds of betrayal of trust and abuse of discretion.

In accordance with the foregoing, the decision of the Tax Court is reversed and the deficiency expunged.

Internal Revenue Code of 1954

Sec. 2503. Taxable Gifts.

(c) Transfer for the Benefit of Minor.—No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of [§2503(b)] if the property and the income therefrom—

(1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and

(2) will to the extent not so expended—

(A) pass to the donee on his attaining the age of 21 years, and

(B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).

Note

1. On facts similar to the *Gilmore* case, the exclusion was denied on the ground that the minor beneficiaries "acquired only 'future interests,' not subject to immediate capture," because at the time the gift was made no guardian was named in the instrument or had been appointed by the appropriate court to exercise the power of termination on their behalf. Moreover, the minors were under the age of 14 and could not,

under applicable state law, themselves apply for the appointment of a guardian. *Stifel* v. *Commissioner*, 197 F.2d 107 (2d Cir. 1952). Does this mean that in the absence of a legal guardian any gift of property, even an electric train, to a young child is necessarily a gift of a future interest because his power to use or sell it is restricted by his legal disabilities? Rev. Rul. 54-400, 54-2 C.B. 319.

2. Section 2503(c) was enacted in 1954. See Wormser, "Changes in Tax Planning Necessitated by the Internal Revenue Code of 1954—Estate and Gift Tax Phases," *4th Annual Tulane Tax Inst.* 77, 86 (1955):

> Many will take advantage of these new rules. Naming an amiable trustee who may be relied upon not to employ the power granted to apply principal and income for the infant, we can use such a trust to make annual gifts within the gift tax exclusions, and to invest and compound. After all, $6,000 per year for twenty years would produce $120,000 of principal, plus the compounding of the net income after taxes at the low rate the trust would pay. It would be interesting to calculate the result, say at a 4 per cent rate, and compare it with what could be left to the child at age 21 if the father had retained his $6,000 per annum and invested and compounded the income at the same rate, after his high taxes. The comparison would have to take into account, of course, that the trust method would pass the aggregate ultimate fund without gift or estate tax, while the retention method would be subject either to an immediate gift tax or an eventual estate tax.

Note that even if the income of such a trust could be used for the support and maintenance of the minor, the income would be taxed to the grantor only if *actually* so applied. Sec. 677(b), *supra*, p. 315.

Would §2503(c)(1) be satisfied if the trustee may distribute principal to the minor only in case of extreme need? Would §2503(c)(2)(B) be satisfied if in the event the minor dies before 21, the principal and expended income are payable as he may appoint, but in default of appointment they are payable to specified persons rather than to his estate? Note that in such a case, the property would go to persons designated by the grantor if the minor dies before he is old enough to exercise a power of appointment. Does §2503(c)(2)(B) require, in other words, that the property must go either to the minor's estate or to persons whom he (rather than the grantor) designates? Even if the property is so payable, it will go to the child's intestate successors if he dies too young to make a will or exercise a power of appointment; and he cannot select his intestate successors.

3. Section 2503(c) describes "a certain type" of gift to a minor that will qualify for the gift tax exclusion, according to the Senate Report on the 1954 Code. S. Rept. No. 1622, 83d Cong., 2d Sess., p. 479. Presumably any other type of gift that qualified under the pre-1954 statute is still eligible for the exclusion.

What is the meaning and effect of the following statement in the same report?

"Where a child's guardian who has control over gifts to a child, is personally responsible for the support of a child, since he must provide for the current needs of the child, it would appear that a valid gift could only be for a child's future benefit." S. Rept., p. 127. In the *Stifel* case, *supra*, the court indicated that had a guardian been named or appointed to exercise the power to terminate the trust there involved, it "would then seem to be proper to consider the actual facts as to the father's influence on the guardian appointed."

See Caplin, "How to Treat Gifts to Minors," *13th Ann N.Y.U. Tax Inst.* 193 (1955); for the pre-1954 law, see Rogers, "Outright Gifts to Minors and the Gift Tax Exclusion," 7 *Tax Law Rev.* 84 (1951); Fleming, "A Different View of Outright Gifts to Minors," *ibid.* 89; Note, Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax, 53 *Col. L. Rev.* 530 (1953).

4. On the problem of a gift of presently non-productive property, see Regs. 108, Sec. 86.11; *Commissioner* v. *Kempner*, 126 F.2d 853 (5th Cir. 1942); see *Roberts* v. *Commissioner*, 143 F.2d 657 (5th Cir. 1944), cert. den., 324 U.S. 841 (1945).

Section D. Computation of the Gift Tax

In addition to the annual exclusion for each donee, the donor is allowed a "specific exemption" of $30,000 (originally $50,000, reduced to $40,000 as of 1936 and to $30,000 as of 1943) to be taken only once, in the year or years chosen by him. He may also deduct gifts to charities and other nonprofit institutions that qualify under §2522(a), in the case of nonresident aliens, only gifts to domestic institutions qualify. (For the treatment of community property and the related "marital deduction" created by the Revenue Act of 1948, see *infra,* pp. 998–1025.) The tax schedule is cumulative, *i.e*, the tax bracket for the current year's gifts is governed by the aggregate sum of the net gifts in 1932 and all succeeding years A tax is first computed (at current rates) on the aggregate sum of the net gifts for 1932 and subsequent years including the current year. Then a tax is computed on the same amount exclusive of the current year's net gifts. The *difference* is the tax due on the current year's gifts.

An example from the regulations may clarify this procedure (Regs. 108, Sec. 86.7):

Example (1) (showing computations of tax for calendar year 1943) A donor makes gifts (other than gifts of future interests in property) during the calendar year 1943 of $30,000 to A and $33,000 to B. After excluding $6,000 for the two donees in accordance with section 1003(b)(3) [of the 1939 Code, see §2504(b), 1954 Code], the total amount of gifts made during that year is $57,000. The specific exemption was previously exhausted and the amount of the net gifts for 1943 is $57,000. The total amount of gifts made by the donor during the preceding years, after excluding $5,000 for each donee for each calendar year in accordance with section 1003(b)(1) [of the 1939 Code], is computed as follows

Calendar year 1934	$120,000
Calendar year 1935	25,000
Total amount of gifts for preceding calendar years	$145,000

The aggregate sum of the net gifts for the preceding calendar years, $115,000, is determined by deducting a specific exemption of $30,000 from $145,000 The deduction for such specific exemption cannot exceed $30,000, even though $50,000 was allowed as the specific exemption in the computation of the tax applicable to the preceding years 1934 and 1935. See section 86 12. The computation of the tax for the calendar year 1943 is shown below

1 Amount of net gifts for year	$ 57,000
2 Total amount of net gifts for preceding years	115,000
3. Total net gifts	$172,000
4. Tax computed on item 3 (in accordance with rate schedule)	$ 31,725
5. Tax computed on item 2 (in accordance with rate schedule)	18,900
6 Tax for year 1943 (item 4 minus item 5)	$ 12,825

House Committee on Ways and Means, 72nd Cong, 1st Sess., recommending enactment of the Revenue Act of 1932 (H. Rept. No 708, 39-1 C.B (Part 2) 477):

The computation of the tax payable each year involves three operations, namely

(1) A computation of the tax at the graduated rates on all gifts (with certain express

exceptions) made after the enactment of this Act, including gifts made in the current calendar year; (2) a computation of the tax at the graduated rates on the gifts made in the prior year or years; (3) the subtraction of the result of the second computation from that of the first. This computation results in a tax imposed on a cumulative basis. In short, the design is to impose a tax which measurably approaches the estate tax which would have been payable on the donor's death had the gifts not been made and the property given had constituted his estate at his death. The tax will reach gifts not reached, for one reason or another, by the estate tax.

The gift tax will supplement both the estate tax and the income tax It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax.

An objection urged against the former gift tax (that imposed by the Revenue Act of 1924) was that it might be readily evaded by spreading the gifts over a period of years. Under that tax a person could in each year make gifts equal to the deductions, including the specific exemption, and thus escape the tax entirely. Where taxable gifts were spread over a number of years, the combined effect of the annual specific exemption and of the graduated rates resulted in the aggregate of the gift taxes imposed being much less than what the tax would have been had all the gifts been made in a single year. If a gift tax is to yield a material revenue it is necessary that it be imposed on a cumulative basis as is the proposed tax. Since the gift tax is an adjunct of the estate tax which is not restricted to transfers made within a single year, an effective gift tax must give consideration, so far as the rate of tax is concerned, to transfers made in prior years.

The theory upon which the gift tax is based is that the rate of tax is measured by all gifts made after the enactment of the bill. This scheme is adopted in order to tax gifts made over a period of years at the same rate as if they had all been made within one year For a more effective administration and to secure prompt collection of the revenues, the bill provides that the tax shall be computed and collected annually.

Note

1. In the computation above, the amount of $18,900 (line 5) representing a tax on the gifts for preceding years, is not the amount *actually* paid in 1934 and 1935. The discrepancy results from the fact that when tax was paid for those years, the specific exemption was $50,000, moreover, the rates were lower and have been raised several times in the intervening years.

2. Suppose that the 1934 and 1935 gifts had been of future interests in property and that the donor had (innocently) taken exclusions of $5,000 each with respect to these gifts. Section 6501(a) provides that ordinarily the tax "shall be assessed within 3 years after the return was filed . . . and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period." * This does not prevent a denial of the $5,000 exclusion to the 1934 and 1935 gifts in computing the tax liability for 1943. *Commissioner* v. *Disston*, 325 U.S. 442 (1945).

3. A taxpayer made transfers in 1943 that he did not report, erroneously believing that they were not subject to gift tax. He made taxable transfers in 1947, claiming for that year the entire specific exemption of $30,000. On discovering, either through his own efforts or at the instance of the Commissioner, his 1943 error, he filed a return for that year, claiming the $30,000 specific exemption, and an amended return for 1947, eliminating the specific exemption. May he do so? *Richardson* v. *Commissioner*, 126 F.2d 562 (2d Cir. 1942). What advantage would the taxpayer gain from the amendment?

* The period is 6 years if the taxpayer omits items in excess of 25 per cent of the total amount of gifts reported in the return, §6501(e)(2); and there is no time limit on assessments if no return is filed or if the return is fraudulent, §6501(c).

If the donor overvalued his gifts in earlier years and therefore exhausted his specific exemption unnecessarily, it has been held that he may later correct the overvaluation in computing the amount of the specific exemption left for use in subsequent years. *Schuhmacher* v. *Commissioner*, 8 T.C. 453 (1947), see also *Lockard* v. *Commissioner*, *supra*, p. 944. Can this decision be reconciled with the statutory injunction that the amount of the specific exemption is $30,000 "less the aggregate of the amounts *claimed and allowed* as specific exemption" in prior years, §2521? See *Virginian Hotel Corp.* v. *Helvering*, 319 U S. 523 (1943), *supra*, p. 269.

See also §2504(c), enacted in 1954, applicable only if a gift tax was assessed or paid for the earlier year.

Chapter 11

THE GROSS ESTATE: PROPERTY OWNED AT DEATH

Section A. In General: Sections 2031(a) and 2033

Internal Revenue Code of 1954

Sec. 2031. Definition of Gross Estate.

(a) General.—The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States.

Sec. 2033. Property in which the Decedent Had an Interest.

The value of the gross estate shall include the value of all property (except real property situated outside of the United States) to the extent of the interest therein of the decedent at the time of his death

Note

1. In *New York Trust Co.* v. *Eisner*, 256 U S 345 (1921), the statute was attacked "as an unconstitutional interference with the rights of the states to regulate descent and distribution and as a direct tax not apportioned as the Constitution requires." The Court, through Mr. Justice Holmes, answered·

> The statement of the constitutional objections urged imports on its face a distinction that, if correct, evidently hitherto has escaped this Court. See *United States* v. *Field*, 255 U.S 257. It is admitted, as since *Knowlton* v. *Moore*, 178 U.S. 41, it has to be, that the United States has power to tax legacies, but it is said that this tax is cast upon a transfer while it is being effectuated by the State itself and therefore is an intrusion upon its processes, whereas a legacy tax is not imposed until the process is complete. An analogy is sought in the difference between the attempt of a State to tax commerce among the States and its right after the goods have become mingled with the general stock in the State. A consideration of the parallel is enough to detect the fallacy. A tax that was directed solely against goods imported into the State and that was determined by the fact of importation would be no better after the goods were at rest in the State than before. It would be as much an interference with commerce in one case as in the other. *Darnell & Son Co.* v. *Memphis*, 208 U.S. 113. *Welton* v. *Missouri*, 91 U.S. 275. Conversely if a tax on the property distributed by the laws of a State, determined by the fact that distribution has been accomplished, is valid, a tax determined by the fact that distribution is about to begin is no greater interference and is equally good.
>
> *Knowlton* v. *Moore*, 178 U.S. 41, dealt, it is true, with a legacy tax. But the tax was met with the same objection; that it usurped or interfered with the exercise of state powers, and the answer to the objection was based upon general considera-

> tions and treated the "power to transmit or the transmission or receipt of property by death" as all standing on the same footing. 178 U.S. 57, 59. After the elaborate discussion that the subject received in that case we think it unnecessary to dwell upon matters that in principle were disposed of there. The same may be said of the argument that the tax is direct and therefore is void for want of apportionment. It is argued that when the tax is on the privilege of receiving, the tax is indirect because it may be avoided, whereas here the tax is inevitable and therefore direct. But that matter also is disposed of by *Knowlton* v. *Moore*, not by an attempt to make some scientific distinction, which would be at least difficult, but on an interpretation of language by its traditional use—on the practical and historical ground that this kind of tax always has been regarded as the antithesis of a direct tax; "has ever been treated as a duty or excise, because of the particular occasion which gives rise to its levy." 178 U.S. 81–83. Upon this point a page of history is worth a volume of logic.
>
> The inequalities charged upon the statute, if there is an intestacy, are all inequalities in the amounts that beneficiaries might receive in case of estates of different values, of different proportions between real and personal estate, and of different numbers of recipients; or if there is a will affect legatees. As to the inequalities in case of a will they must be taken to be contemplated by the testator. He knows the law and the consequences of the disposition that he makes. As to intestate successors the tax is not imposed upon them but precedes them and the fact that they may receive less or different sums because of the statute does not concern the United States.

The federal estate tax was again upheld, against a farrago of additional contentions, in *Heitsch* v. *Kavanagh*, 200 F.2d 178 (6th Cir. 1952), cert. den, 345 U S 939

See generally, Eisenstein, "Estate Taxes and the Higher Learning of the Supreme Court," 3 *Tax L. Rev.* 395, 397–408 (1948).

2. From 1916 to 1926, §811(a) (the predecessor of §2033) provided for the inclusion of all property to the extent "of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate." In *Crooks* v. *Harrelson*, 282 U.S. 55 (1930), it was held that Missouri real estate was not subject to tax, that state not having modified the common law rule that a decedent's real estate is not subject to the expenses of administering his estate. The proviso had already been eliminated, by the Revenue Act of 1926, "in the interest of certainty." H. Rept. No. 1, 69th Cong., 1st Sess., 1939–1 C.B. (Part 2) 325.

3. The exclusion of "real property situated outside of the United States" from the federal estate tax, §§2031(a) and 2033, has created some problems of classification. In *Estate of De Perigny* v. *Commissioner*, 9 T.C. 782 (1947), certain long-term leases on real property in Kenya were held to be exempt, in *Fair* v. *Commissioner*, 91 F.2d 218 (3d Cir. 1937), exemption was granted to Cuban "hipotecas" (similar to mortgages); and in *Laird* v. *United States*, 115 F. Supp. 931 (D. Wisc. 1953), renewable Canadian timber leases (authorizing the lessee to cut timber upon the leased property upon the payment of an annual fee and certain taxes) were exempted. See Note, 37 *Col. L. Rev.* 500 (1937); Note, 46 *Yale L. J.* 687 (1937), Rev. Rul. 65, 53–1 C.B. 391.

As to the policy underlying the exemption, the Senate Finance Committee (S. Rept. No. 558, 73d Cong., 2d Sess., 1939–1 C B. (Part 2) 621) said·

> Your committee is of the opinion that real property located abroad should not be subject to the Federal estate tax since it is an almost universally established principle of estate taxation that real estate should be subject to death duties only in the country where situated. To tax such real estate, will make it difficult for many American citizens to live in foreign countries in the interest of American foreign trade, for they will be subject to a tax burden much greater than that imposed on foreigners in a similar situation. Accordingly, your committee has amended the House bill to make it clear that real estate located abroad shall not be subject to the Federal estate tax The effect of this amendment with other amendments made by

the House is to place nonresident American citizens in the same category as residents and thus subject them to the estate tax with respect to all of their property except real property located abroad.

Does the exemption accomplish more than its announced purpose? Does it embrace shares of a corporation owning foreign real property? Foreign real property which the decedent contracted to sell or directed his executor to sell?

What is the status of tangible personal property located abroad? *Guaranty Trust Co.* v. *Commissioner*, 79 F.2d 245 (2d Cir. 1935).

Note that foreign real property is not exempt from the federal gift tax, unless the donor is a nonresident alien. §2511(a).

4. Double taxation. American citizens and resident aliens are taxed by §2031 upon "all property . . . wherever situated" (except foreign realty) and hence are subject to double taxation if they own property within the jurisdiction of another country. The burden of double taxation is partially mitigated by treaties with a number of foreign countries under which the country of citizenship or domicile agrees to allow the decedent's estate a credit for foreign death taxes paid on property having its "situs" in the other contracting country. Situs is defined by the treaties; the treaty with the United Kingdom, for example, provides that tangible property has its situs in the country where it is physically located, corporate shares in the country of incorporation, insurance proceeds, bonds, and bank deposits in the country of the owner's domicile, judgment debts in the country of recordation, *etc.* A list of the treaties in force and under negotiation may be found in 1955–24 I.R.B., p. 25. See also Gornick, "The Canadian and British Death Tax Conventions," 50 *W. Va. L. Q.* 55 (1946); Rado, "Estate Tax Convention between Great Britain and the United States," 2 *Tax L. Rev.* 479 (1947); Sweeney, "Nonresident Estate Taxes Under the United States and United Kingdom Convention," 25 *Taxes* 903 (1947). Would it be more desirable for each of the treaty countries to tax only its own domiciliaries? See Griswold, "The Canadian Death Tax Convention," 23 *Taxes* 402 (1945).

Because treaties have not been negotiated with all foreign countries imposing death taxes on American citizens and resident aliens, and because in some instances the treaties do not produce complete relief against double taxation, Congress enacted in 1951 a statutory credit for foreign death taxes. This provision, §2014, permits the estate to credit against its American estate tax liability, as a kind of down payment, the death taxes paid to any foreign country "in respect of any property situated within such foreign country and included in the gross estate." The situs rules to be applied are those prescribed by §§2104-5 for determining the situs of property owned by a nonresident alien in computing his gross estate. There are several limitations on the credit, the principal one is that if the United States taxes the property at a lower effective rate than the foreign country, only the lower amount can be credited.

Where §2014 overlaps a treaty, the larger credit may be taken. For a detailed examination of the effect of §2014 and the Canadian treaty on Canadian investments by American citizens and resident aliens, see Molloy and Woodford, "Estate Planning Techniques and the Ownership of Canadian Securities," 62 *Yale L J.* 147 (1953). These authors conclude: "Three different sets of situs rules—those laid down in the Convention, those under the Code, and those applicable to [the provincial death taxes of] Ontario and Quebec—must be mastered and applied when making *inter vivos* investments and when drafting wills. . . . Proper will drafting techniques can save as much as 14.8 percent of the total combined death taxes otherwise payable on a net Federal estate of U.S. $500,000, 7.8 percent in the case of a U.S. $1,000,000 estate, and 11.08 percent in the case of a U.S. $2,000,000 estate, without the slightest alteration in the substantive dispositive provisions of such will." (62 *Yale L J* at 169-70)

5. Nonresident aliens: In the case of a nonresident alien, the estate tax is imposed on the transfer of only "that part of his gross estate (determined as provided in section 2031) which at the time of his death is situated in the United States." §2103. In *Burnet* v *Brooks*, 288 U S 378 (1933), the statute was upheld as to, *inter alia*, bonds of foreign governments and corporations owned by a British subject resident in Cuba,

the basis of jurisdiction being that the bonds were in the possession of the decedent's American agents. See Regs. 105, Sec. 81.50, providing that "the written evidence of intangible personal property which is treated as being the property itself" (*e.g.*, a corporate bond) is part of the gross estate if physically situated here; other debts are part of the gross estate only if the debtor is located in the United States. Under §2104(a), enacted in 1954, however, shares of stock of foreign corporations are not included in the gross estate, regardless of where the certificates are located.

The scope of §2103 is qualified by §2105(a), exempting life insurance proceeds, and by §2105(b), exempting "moneys deposited with any person carrying on the banking business" if the decedent was not engaged in business here at the time of his death. See also §2106(c). For the estate tax status of property that is located in the United States only temporarily, see *Delaney* v. *Murchie*, 177 F.2d 444 (1st Cir. 1949). See also §2105(c), exempting from tax works of art owned by a nonresident alien if loaned for exhibition to a non-profit gallery or museum This exemption originally applied only to works exhibited at the National Gallery of Art in Washington, 64 Stat. 576, and was apparently intended to protect a collection of paintings lent to that gallery by an 81-year old Armenian art collector. See Coughlan, "Mystery Billionaire," *Life*, Nov. 27, 1950, p. 81.

The estate of a nonresident alien is entitled to an exemption of only $2,000 and its deductions are subject to special limitations, as set out in §2106. The estate may, of course, be entitled in the country of domicile to a credit for the United States tax, under the treaties mentioned *supra*, or under other provisions of local law. See generally Wurzel, "Nonresident Aliens and Federal Estate Tax: A Legislative Problem," 40 *Col. L. Rev.* 52 (1940).

Transfers by nonresident aliens are also exempt from gift tax under certain conditions, but the exemptions are not identical with those granted by the estate tax law To be subject to gift tax, the property must be "situated within the United States," as in the case of the estate tax, and shares of stock are included only if issued by a domestic corporation, §§2511(a) and (b). See Regs. 108, Sec. 86.18, *Wodehouse* v. *Commissioner*, 19 T.C. 487 (1952). A transfer of intangible property is exempt if the alien is not engaged in business in this country, §2501(a). Such persons are also granted immunity in the case of a transfer of obligations of the United States issued before March 1, 1941, Regs. 108, Sec. 86.2. As to the purchase of such obligations for the purpose of making a tax-free gift, see *DeGoldschmidt-Rothschild* v. *Commissioner*, 168 F 2d 975 (2d Cir. 1948).

6. Income tax basis. In the income tax part of this book, it was pointed out that the "basis" to the recipient of property acquired by bequest, inheritance, or devise is its fair market value at the time of the decedent's death. §1014(b)(1), *supra*, p 125 According to the income tax regulations, this means the value of the property "as appraised for the purpose of the Federal estate tax" if the estate is subject to estate tax. Regs. 118, Sec. 39.113(a)(5)-1(c). Although this valuation, under the cases, does not preclude the heir or legatee from proving a higher value, it will at least be entitled to a presumption of correctness. Where the estate includes property of uncertain or disputed value, a high estate tax value may be advantageous to the heir or legatee, and his immediate or eventual income tax savings may exceed the resulting additional estate tax. Would the executor violate his fiduciary duty to the estate if he voluntarily placed a high value on such property or accepted without contest a high valuation asserted by the government? Would it be improper for the heir or legatee to reimburse other persons interested in the estate to the extent that the additional estate tax burden would fall on them? See Beck, "To What Extent Are the Executor and the Beneficiary Bound by Estate Tax Valuation?" *9th Annual N.Y.U. Inst. on Fed. Tax.* 259, 273–8, 280–4 (1951); Rev. Rul. 54–97, 54–1 C.B. 113. On the question whether the income tax basis of inherited property may be adjusted upward to reflect the estate tax paid on the transfer of the property to the beneficiary, see *Estate of Levy* v. *Commissioner*, 17 T.C. 728 (1951); Marshall, "Basis of Property Subject to Estate Tax Under I.R.C. Sections 811(c) and 811(d)." 26 *So. Calif. L. Rev.* 111, 123–9 (1953).

The fact that appreciated property takes on a "stepped-up" basis at death is important to the estate planner, and it may also have an effect upon the liquidity of investments, especially on those held by older persons. (Depreciated property takes on a "stepped-down" basis on the owner's death, but this fact is counter-balanced to a degree by the owner's power to sell during his lifetime if the income tax deduction for the decline in value will be useful to him.)

RHODES v. COMMISSIONER

Board of Tax Appeals, 1940
41 B.T.A. 62

BLACK, *Judge.*

The estate tax and the additional estate tax imposed by sections 301(a) of the Revenue Act of 1926 and 401(a) of the Revenue Act of 1932, respectively, are "upon the transfer of the net estate of every decedent. . . ." The term "net estate" means the "gross estate" as defined in section 302 of the Revenue Act of 1926 as amended, less the deductions specified in Section 303 as amended. See also section 300(b), Revenue Act of 1926. The respondent determined that, under subdivision (a) of section 302 of the Revenue Act of 1926 [§§2031(a) and 2033, 1954 Code], the value of decedent's gross estate was $289,175.79, $242,500 of which represented the value of 5,000 shares of common stock of the International Shoe Co. Subdivision (a) provides as follows:

Sec. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated —

(a) To the extent of the interest therein of the decedent at the time of his death. . . .

What was the decedent's "interest" in the property the value of which the respondent has included in the decedent's gross estate? The respondent contends that the decedent was the sole owner of all the property which she attempted to dispose of in her will, including the shares of International Shoe Co. stock assigned to her by her children on or about July 30, 1925, and that the two decrees of the Circuit Court of St. Louis County, Missouri, referred to in our findings, are not binding upon the Board as requiring a holding contrary to the respondent's determination.

Petitioners contend that the determination of the decedent's "interest" in the property in question is purely one of the determination of property rights, and, as such, is controlled by the two decrees of the local circuit court.

We agree with the petitioners' contention. If the decedent owned only a life estate in the International Shoe Co. stock assigned to her in 1925 by her children, no part of the value of such property so assigned should be included in her gross estate, only her own share of the stock which she inherited from her husband's estate, which was one-fifth, should be included. Article 11 of Regulation 70, 1929 ed. and Regulations 80, 1934 ed., and article 13 of Regulation 80, 1937 ed., all provide: "Nor shall anything be included [in the decedent's gross estate] on account of an interest or an estate limited for the life of the decedent." The determination of whether the decedent owned only a life estate in the property assigned to her in 1925 by her children or whether she owned an absolute interest

therein is clearly a determination of property rights, and, as such is controlled by local law. *Poe* v. *Seaborn*, 282 U.S. 101; *Tyler* v. *United States*, 281 U.S. 497; *Freuler* v. *Helvering*, 291 U.S. 35; *Blair* v. *Commissioner*, 300 U.S. 5; . . .

The Circuit Court for the County of St. Louis, State of Missouri, Division No. 2, after a full hearing in the matter, decreed on March 21, 1935, that the assignment executed by the children on July 30, 1925, "be and the same is hereby reformed as of the date of its execution to read" that the children "hereby jointly and severally grant, transfer and assign to our said mother, Mamie D. Rhodes, an estate, for her life only, in and to our joint and several interests in said estate of Taylor Rhodes, deceased. . . ." The assignment as reformed also provided that upon the death of Mamie D. Rhodes "that certain life estate which we hereby assign to her shall terminate and our said joint and several interests shall thereafter be held and owned by us as if this instrument had not been executed."

There is no evidence that this decree was obtained for the purpose of defeating any Federal estate tax, or that it was obtained by collusion. Such evidence as we do have points to the fact that it was a decree rendered after there was a hearing on the merits and was not a mere consent decree. The respondent has placed in evidence before us the testimony of Leona Kemp, who testified at the hearing before the local circuit court held on March 15, 1935. The substance of her testimony was that she was the secretary to W. E. Baird, the attorney who prepared the original assignment, that Baird had since died, that prior to the preparation of the assignment she remembered seeing "Mr. and Mrs. Paul Rhodes and Mr. Hugh Rhodes" at Baird's desk, which was adjacent to her own, that she "heard Mr. Paul Rhodes tell Mr Baird he wanted to have him draw up a document whereby they could give their share of the estate to their mother for the time of her life, and Mr. Baird made a notation on his calendar pad", that about four or five days later, Baird placed a paper written in longhand on her desk and asked her to copy it, and that the paper thus handed to her was the original assignment. All of the evidence before us, including recitals in the decree itself, indicates that the decree was rendered after a hearing on the merits and was in every respect regular. It was a decree adjudicating property rights There is no evidence that it was ever modified or reversed, and, upon the authority of the above cited cases, it must be taken as establishing conclusively that the children assigned to their mother only a life estate in their interest in their father's estate.

Shortly after the reformation decree J. Jackson Rhodes and Hugh D. Rhodes, individually, and as executors and trustees under the will of Mamie D. Rhodes, deceased, filed a suit in the Circuit Court of the County of St. Louis, State of Missouri, May term, 1935, against Paul T. Rhodes, individually and as one of the trustees under the will of Mamie D. Rhodes, deceased, and Mary B. Rhodes, praying "for a decree of this court determining the ownership of all of the property held in the name of Mamie D. Rhodes at the time of her death on January 22, 1934, as between the estate of said Mamie D Rhodes on the one hand and the plaintiffs and defendants herein on the other, and for such other and further orders and decrees as to the court may seem just and proper." The circumstances surrounding this suit are fully set out in our findings and need not be repeated here. Suffice it to say that on June 5, 1935, the court handed down its decree, in which it gave full faith and credit to the decree of the Circuit Court of

the County of St. Louis, Division No. 2, heretofore mentioned and discussed.

It is our opinion that the two decrees in evidence before us establish conclusively that the decedent did not own outright any more than one-fifth of the 5,000 shares of common stock of the International Shoe Co. which the respondent has included in her gross estate and we have so found in our findings of fact. Her "interest" in the remaining four-fifths of the 5,000 shares was a life interest, which ceased with her death, and under the above cited provisions of the respondent's regulations it was error for the respondent to include as a part of the decedent's gross estate the value of 4,000 shares, amounting to $194,000. . . . Even if it should be held that the second court decree rendered by Division No. 3, June 5, 1935, was a consent decree because it followed substantially the lines of a written agreement which had been previously entered into by the parties, nevertheless, the first court decree of Circuit Court No. 2, reforming the original instrument of transfer, was not a consent decree and settled the question as to ownership of the International Shoe Co. common stock and we are bound by it.

The respondent stresses the importance of the fact that the decedent, after the original assignment from her children in 1925, thereafter treated the property as her own. It is true that she so testified in the affidavit* referred to in our findings; that she actually sold 3,000 shares of the stock; that she pledged the remaining stock on loans; and that she attempted to dispose of all the stock in her will. As we look at this case, those were the facts for the local circuit court to consider in arriving at its decision in the matter. We may not assume that it did not do so. The decree having been rendered by a court of competent jurisdiction in a suit between adverse parties after a hearing upon the merits, we feel that we are bound by it. Whether the decree ever should have been rendered under the evidence is not a matter for us to decide. The question of property rights there decided is no longer an open question for the Board or the Federal Courts to consider. *Freuler* v. *Helvering; Blair* v. *Commissioner; Sharp* v. *Commissioner*, all *supra*.

The conclusion which we here reach is not contrary to our recent decision in *Estate of Arthur D. Forst*, 40 B.T.A. 876. In that case we held that a decree of the Orphans' Court of Mercer County, New Jersey, approving a certain claim against the estate was not binding upon the Board as to whether the claim was deductible under section 303 of the Revenue Act of 1926, in arriving at the net estate.† The question was altogether different from the one we have here to decide. Congress has established its own criterion as to what claims are deductible. *Cf. Lyeth* v. *Hoey*, 305 U.S. 188.

In view of our holding on the first issue, we need not decide the second issue.

Reviewed by the Board.

Decision will be entered for the petitioners.

STERNHAGEN, dissenting.

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* In connection with the settlement of her husband's estate tax liability, the decedent had filed an affidavit that her children had assigned to her their interests in his estate and that she was the sole person interested in her husband's estate. 41 B.T.A. at 62. [Ed.]

† The corresponding provision of the 1954 Code is §2053(a), allowing a deduction for such claims against the estate "as are allowable by the laws of the jurisdiction . . . under which the estate is being administered." [Ed.]

I do not think that this Board is universally bound by a decree of a state court without regard for the circumstances in which it is rendered. The record in this proceeding does not prove that there was a substantial controversy in which the mother or her estate was unsuccessful in establishing that when she died she owned the International shares and in which the children established against opposition that she had but a life estate. On the contrary it proves that the state court decree was the sanction of a mutually satisfactory agreement in which no one — the administrator *ad litem*, the creditors, the heirs and legatees, or anyone else — was adversely interested. Whether that was an arrangement deliberately aimed at the Federal Government's tax interest in the decedent's estate, it is not possible to say, but that still leaves it less than an adversary proceeding resulting in a judicial decree immune to Federal question. Generally I think my brother Opper * has correctly analyzed the state court proceedings and shown the fallacy of recognizing the decree as binding here.

Note

1 In affirming, the Court of Appeals for the Eighth Circuit (*Helvering* v. *Estate of Rhodes*, 117 F.2d 509, 510 (1941)) said:

> We are not unmindful of the argument for the Commissioner that instances may arise in which "the effect of accepting decrees of state courts as binding determinations of issues of fact presented in federal tax cases . . . would frequently be more undesirable" and that "the federal revenue could suffer considerably if the Commissioner were bound . . . in determining the taxability of the interests involved." But here an administrator *ad litem* was duly appointed and empowered to defend the estate of Mamie D. Rhodes, deceased, against an adversary suit. There is no evidence of any fraud or collusion or failure on the part of the administrator *ad litem* to perform his duty to defend the estate in good faith. Whether, if there had been such evidence, the Board of Tax Appeals could have disregarded the state court decree, it is not necessary to decide. The court had jurisdiction of the parties and the subject matter and the Board rightly held that the state court decrees were binding and determinative of the ownership of the property involved, and that ownership was not in Mamie D. Rhodes at the time of her death. See *Blair* v. *Commissioner*, 300 U.S. 5 (1937) and *Sharp* v. *Commissioner*, 303 U.S. 624 (1938), reversing *per curiam* 91 F.2d 802 (C.C.A. 3d 1937)

2 *A* established a testamentary trust, directing that the income be distributed "at such times and in such amounts as [the] trustee shall deem best" equally to *B*, *C*, and *D*. At *B*'s death, the trust held a substantial sum of accumulated, undistributed income. Thereafter, this sum *inter alia* was distributed by order of the probate court to *C* and *D*, who were the residuary beneficiaries of both *A* and *B*, as "the only persons interested in said [*A*'s] estate." Does this order preclude an independent finding by the Tax Court that one-third of the accumulated trust income was an asset of *B*'s estate? *Earle* v. *Commissioner*, 157 F.2d 501 (6th Cir. 1946), cert. den., 330 U.S. 822 (1947). See *First-Mechanics National Bank* v. *Commissioner*, 117 F.2d 127 (3d Cir. 1940), *Commissioner* v. *Childs' Estate*, 147 F.2d 368 (3d Cir. 1945); *Krag* v. *Commissioner*, 8 T.C. 1091 (1947). Does an appeal guarantee that a proceeding is adversary? *Kelly's Trust* v. *Commissioner*, 168 F.2d 198 (2d Cir. 1948).

3. Is there a difference in effect between a state court's findings of fact and its conclusions of law? Would it be feasible to permit or to require the United States to

* The dissenting opinion of Judge Opper, in which Judges Hill and Disney joined, is omitted. [Ed.]

intervene in litigation that will affect the tax liability of the parties? Cardozo, "Federal Taxes and the Radiating Potencies of State Court Decisions," 51 *Yale L.J.* 783 (1942) (Mr. Cardozo was counsel in *Helvering* v. *Estate of Rhodes, supra*). See also Cahn, "Local Law in Federal Taxation," 52 *Yale L.J.* 799 (1943); Paul, "The Effect on Federal Taxation of Local Rules of Property," in *Studies in Federal Taxation*, 2d series (1938); Sonnenschein, "The Binding Effect of a State Court Decree with Reference to Property Rights Affected by Federal Taxation," 7 *Fed. B.J.* 251 (1946); Note, 61 *Harv. L. Rev.* 1033 (1948).

4. Is property includible if the decedent held title as trustee for the benefit of others? If he was the beneficial but not the record owner? See Regs. 105, Sec. 81.13. What of property transferred to the decedent to hinder, delay, or cheat the transferor's creditors? Of property so transferred *by* the decedent? See *McCann* v. *Commissioner*, 87 F.2d 275 (6th Cir. 1937). An *inter vivos* transfer by the decedent may be vulnerable for various reasons (the transferor's minority, mental incapacity, and so on); conversely, the decedent may have received property in a tainted transaction. Should taxability turn on whether the transfer was "void" rather than "voidable"? On whether the transferor or only his creditors may recover the property? On whether an action for its recovery has or has not been brought by the decedent's executor (or by the transferor against the executor)? *Safe Deposit & Trust Co.* v. *Tait*, 54 F.2d 383 (D. Md. 1931), 70 F.2d 79 (4th Cir. 1934). See *supra*, pp.917-8.

What criteria govern the recognition of a family partnership under the estate tax? In *Kihchel* v. *United States*, 105 F.Supp. 523 (W.D. Pa. 1952), the court assumed without discussion that the test is the same as for the income tax, *viz.*, whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner* v *Culbertson*, 337 U.S. 733, 742 (1949) Should the estate tax test be less strict so that a partnership that is ineffective to split income may nevertheless serve to reduce the estate of the head of the family and to increase the estate of his wife or child? Note that §704(e) (*supra*, pp.348–51) applies "for purposes of this [income tax] subtitle." Does it shed any light on the estate tax liability of the parties?

HELVERING v. SAFE DEPOSIT & TRUST CO.

Supreme Court of the United States, 1942
316 U.S. 56

MR. JUSTICE BLACK delivered the opinion of the Court.

Because of the importance in the administration of the Federal Estate Tax of the questions involved, we granted certiorari to review the judgment of the Circuit Court of Appeals, 121 F.2d 307, affirming a decision of the Board of Tax Appeals, 42 B.T.A. 145.

Zachary Smith Reynolds, age 20, died on July 6, 1932. At the time, he was beneficiary of three trusts. one created by his father's will in 1918, one by deed executed by his mother in 1923, and one created by his mother's will in 1924. From his father's trust, the decedent was to receive only a portion of the income prior to his twenty-eighth birthday, at which time, if living, he was to become the outright owner of the trust property and all accumulated income. His mother's trust directed that he enjoy the income for life, subject to certain restrictions before he reached the age of 28. Each of the trusts gave the decedent a general testamentary power of appointment over the trust property; in default of exercise of the power the properties were to go to his descendents, or if he had none, to his brother and sisters and their issue *per stirpes*.

The Commissioner included all the trust property within the decedent's gross

estate for the purpose of computing the Federal Estate Tax. The Board of Tax Appeals and the Circuit Court of Appeals, however, held that no part of the trust property should have been included.

I

The case presents two questions, the first of which is whether the decedent at the time of his death had by virtue of his general powers of appointment, even if never exercised, such an interest in the trust property as to require its inclusion in his gross estate under §302(a) of the Revenue Act of 1926 [§§2031(a) and 2033, 1954 Code]. This section provides:

> The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—
>
> (a) To the extent of the interest therein of the decedent at the time of his death;

The Government argues that at the time of his death the decedent had an "interest" in the trust properties that should have been included in his gross estate, because he, to the exclusion of all other persons, could enjoy the income from them; would have received the corpus of one trust upon reaching the age of 28, and could alone decide to whom the benefits of all the trusts would pass at his death. These rights, it is said, were attributes of ownership substantially equivalent to a fee simple title, subject only to specified restrictions on alienation and the use of income. The respondents deny that the rights of the decedent with respect to any of the three trusts were substantially equivalent to ownership in fee, emphasizing the practical importance of the restrictions on alienation and the use of income, and arguing further that the decedent never actually had the capacity to make an effective testamentary disposition of the property because he died before reaching his majority.

We find it unnecessary to decide between these conflicting contentions on the economic equivalence of the decedent's rights and complete ownership.[1] For even if we assume with the Government that the restrictions upon the decedent's use and enjoyment of the trust properties may be dismissed as negligible and that he had the capacity to exercise a testamentary power of appointment, the question still remains Did the decedent have "at the time of his death" such an "interest" as Congress intended to be included in a decedent's gross estate under §302(a) of the Revenue Act of 1926? It is not contended that the benefits during life which the trusts provided for the decedent, terminating as they did at his death, made the trust properties part of his gross estate under the statute. And viewing §302(a) in its background of legislative, judicial, and administrative history, we cannot reach the conclusion that the words "interest . . . of the decedent at the time of his death" were intended by Congress to include property subject to a general testamentary power of appointment unexercised by the decedent.

[1] In declining to pass upon this issue, we do not reject the principle we have often recognized that the realities of the taxpayer's economic interest, rather than the niceties of the conveyancer's art, should determine the power to tax. See Curry v. McCanless, 307 U.S 357, 371, and cases there cited. Nor do we deny the relevance of this principle as a guide to statutory interpretation where, unlike here, the language of a statute and its statutory history do not afford more specific indications of legislative intent. Helvering v. Clifford, 309 U S 331.

The forerunner of §302(a) of the Revenue Act of 1926 was §202(a) of the Revenue Act of 1916, 39 Stat. 777. In *United States* v. *Field*, 255 U.S. 257, this Court held that property passing under a general power of appointment *exercised* by a decedent was not such an "interest" of the decedent as the 1916 Act brought within the decedent's gross estate. While the holding was limited to *exercised* powers of appointment, the approach of the Court, the authorities cited, and certain explicit statements [2] in the opinion left little doubt that the Court regarded property subject to *unexercised* general powers of appointment as similarly beyond the scope of the statutory phrase "interest of the decedent." [3]

After the *Field* case, the provision it passed upon was reenacted without change in the Revenue Act of 1921 and in the Revenue Act of 1924. If the implications of the *Field* opinion with respect to unexercised powers had been considered contrary to the intendment of the words "interest of the decedent," it is reasonable to suppose that Congress would have added some clarifying amendment. . . .

When it was held in the *Field* case that property subject to an *exercised* general testamentary power of appointment was not to be included in the decedent's gross estate under the Revenue Act of 1916, this Court referred to an amendment passed in 1919 which specifically declared property passing under an exercised general testamentary power to be part of the decedent's gross estate. The passage of this amendment, said the Court "indicates that Congress at least was doubtful whether the previous act included property passing by appointment." [4] In the face of such doubts, which cannot reasonably be supposed to have been less than doubts with respect to *unexercised* powers, Congress nevertheless specified only that property subject to exercised powers should be included. From this deliberate singling out of *exercised* powers alone, without the corroboration of the other matters we have discussed, a Congressional intent to treat *unexercised* powers otherwise can be deduced. At the least, §302(f) of the 1926 Act,[5] the counterpart of the 1919 amendment referred to in the *Field* case, represents a course of action followed by Congress, since 1919, entirely consistent with a purpose to exclude from decedents' gross estates property subject to unexercised general testamentary powers of appointment.

In no judicial opinion brought to our attention has it been held that the gross estate of a decedent includes, for purposes of the Federal Estate Tax, property subject to an unexercised general power. On the contrary, as the court below

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[2] *E.g.* "But the existence of the power does not of itself vest any estate in the donee." (p. 263.)

"If there be no appointment, it [the property subject to the power] goes according to the disposition of the donor." (p 264.)

". . . the interest in question [was] not . . property of Mrs Field at her death." (p. 264.)

[3] In Burnet v. Guggenheim, 288 U S 280, 288, this Court stated "United States v. Field . . holds that under the Revenue Act of 1916 . . . the subject of a power created by another is not a part of the estate of the decedent to whom the power was committed." It is to be noted that no distinction was recognized between exercised and unexercised powers under the rule of the Field case.

[4] United States v. Field, *supra*, 265.

[5] "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

"(f) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth,—" 44 Stat. 9, 70–71.

points out, "the courts have been at pains to consider whether property passed under a general power or not so as to be taxable under Section 302(f), a consideration which would have been absolutely unnecessary if the estate were taxable under 302(a) because of the mere existence of a general power whether exercised or not." 121 F.2d 307, 312. In addition, the uniform administrative practice until this case arose appears to have placed an interpretation upon the Federal Estate Tax contrary to that the Government now urges. No regulations issued under the several revenue acts, including those in effect at the time this suit was initiated, prescribe that property subject to an unexercised general testamentary power of appointment should be included in a decedent's gross estate. Because of the combined effect of all of these circumstances, we believe that a departure from the long-standing, generally accepted[6] construction of §302(a), now contested for the first time by the Government, would override the best indications we have of Congressional intent.

II

[Omitted.]

Reversed.

Note

The powers of appointment provision, which is now §2041, was thoroughly revised in 1942 and again in 1951. The changes are examined in some detail *infra*, pp. 1178–88, but it is worth noting here that if the decedent at the time of his death possesses a general power of appointment created after 1942, the property subject to the power is now includible in his estate even if he does not exercise it

The great significance of the *Safe Deposit & Trust Co.* case is that the Court refuses to read what is now §2033 in the expansive way it came to read §22(a) of the 1939 Code [§61(a), 1954 Code]. The *Clifford* case, *supra*, p. 316, should be studied again, especially for its explanation of the relation between the catch-all language of §22(a) and the specific language of §§166 and 167 of the 1939 Code [§§676 and 677, 1954 Code] Was the legislative history adduced by the taxpayer in the *Clifford* case as compelling as that relied on by the taxpayer in the *Safe Deposit & Trust Co.* case?

Does the *Safe Deposit & Trust Co.* case mean that a *Clifford* trust cannot be included in the grantor's gross estate even though, to quote the *Clifford* opinion, he could not reasonably have "felt himself the poorer after this trust had been executed"? As will be seen, a trust will be part of the grantor's estate if—roughly speaking—he retained the power to alter, amend, or revoke it, if he created it in contemplation of death and died within three years, if he retained a life interest in the income; or if certain other statutory conditions are met So far, §2033 has not been employed as a method of reaching transfers that escape the technical requirements of these other provisions on the ground that the grantor was still the owner "in substance" of the property. The *Safe Deposit & Trust Co.* case may have dampened the Treasury's enthusiasm, or at least its hopes, for such a use of §2033.* But it is one thing to hold that by requiring

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[6] See I Paul, *Federal Estate and Gift Taxation*, p. 425 "As long as there is no actual or constructive exercise of the power, there can be no tax under the present statute"

* On one occasion, the Supreme Court asked counsel in a pending case to argue the relation of the *Clifford* case to estate tax liability. *Estate of Spiegel* v. *Commissioner*, 68 S Ct 1522 The government took the following position in its brief on reargument (p. 53):

> Indeed, it is even arguable that a trust covered by the *Clifford* doctrine should be included in the gross estate under Section 811(a) [§2033, 1954 Code], which in a sense corresponds to the general provisions in Section 22(a) defining gross income. Section 811(a)

property to be included if the decedent *exercised* a general power of appointment, Congress must have intended not to tax it if the power was *unexercised.* It is another thing to assert that the existence of the other specific grounds for taxing transfers (contemplation of death; retained life estates; powers to amend, alter, or revoke; *etc.*) necessarily means that no other property, except that owned outright by the decedent, may be included in the gross estate.

See Greenbaum, "The Clifford Doctrine and the Estate Tax," 6 *Tax L. Rev.* 312 (1951).

SECOND NATIONAL BANK OF DANVILLE v. DALLMAN

U.S. Court of Appeals, Seventh Circuit, 1954
209 F.2d 321

Before MAJOR, Chief Judge, and DUFFY and SWAIM, Circuit Judges.

MAJOR, Chief Judge.

This is an appeal from a judgment entered by the district court on June 9, 1953, adverse to plaintiff, in an action to recover a federal estate tax paid under protest on the estate of Helen L. Abdill, deceased. Plaintiff is a trustee designated under the last will and testament of the said decedent. The portion of her estate upon which the tax was paid and for which the refund is sought is the sum of $30,000, proceeds of a life insurance policy paid by the insurer to the executor of decedent's estate for reasons and under circumstances to be subsequently related.

The district court embraced the findings of fact as stipulated by the parties, with the conclusion of law that plaintiff was not entitled to recover. From the judgment entered in conformity with such conclusion plaintiff appeals.

Helen L. Abdill died testate on September 24, 1945. At the time of her death she was unmarried, and left as her only surviving heirs Lucretia H. Michael, a niece, and Joseph G. C. Houghteling, a nephew. Decedent was the daughter of Ernest X. LeSeure, whose death occurred in April, 1925. The father in 1912 procured from Northwestern Mutual Life Insurance Company a policy of life insurance in the principal amount of $30,000, in which the decedent, his daughter, was named as beneficiary but who, by the terms of the policy, was precluded

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is the basic provision requiring the inclusion in the gross estate of all property owned by the decedent at his death. And where the settlor remains in substance the owner of the trust property for purposes of Section 22(a) under the *Clifford* case, it is highly persuasive that it should be included in his gross estate under Section 811(a), unless there is a specific statute providing otherwise. See *Helvering* v. *Safe Deposit Co.*, 316 U.S 56, 58–59 However, the Government has sought in the present cases merely to include these trusts in Section 811(c) [1939 Code].

The case was decided, as the government intimated it should be, under Section 811(c) of the 1939 Code, rather than under the general language of Section 811(a). The *Clifford* problem, opened up on the Court's own motion, was discussed only in one of the dissenting opinions, Mr. Justice Burton denied that the doctrine of that case was applicable to estate tax field taxation, but he did not cite the *Safe Deposit & Trust Co* case. 335 U.S. at 712–8.

In *Estate of Royce* v. *Commissioner*, 46 B.T.A. 1090 (1942), the government tried to apply the estate tax to property which the decedent had the right to withdraw on demand from a trust created by her husband. Apparently the government thought that the *Safe Deposit & Trust Co.* case was distinguishable because it involved a testamentary power of appointment, while the *Royce* case involved a power exercisable during life. The court held that the decedent had no "interest" in the trust corpus.

from effecting its surrender and from ever receiving any part of the principal amount.

Option "A" provided that the principal amount should upon the death of the insured be retained by the insurer during the life of his daughter (decedent), and that during such period she should receive an annuity of 3% per annum upon the principal amount thus retained by the insurer. This annuity, which amounted to the sum of $900.00 per annum, was paid to her by the insurer as directed. Option "A" also provided that "The Beneficiary . . . shall . . . have the right, with the privilege of revocation and change, to designate a Contingent Beneficiary or Beneficiaries whose interest shall be as expressed in, or endorsed by the company on, this Policy . . . ," provided, however, "No election, direction, designation, revocation or change shall be effective unless duly made in writing and filed at the Home Office of the Company (accompanied by the Policy for suitable endorsement) prior to or at the time this Policy shall become payable." And, "Unless otherwise directed by the designator and so endorsed by the Company on this Policy, the Contingent Beneficiary or Beneficiaries, if any, shall, upon satisfactory proof of the death of the last surviving Beneficiary, succeed to all the interest, rights and privileges then possessed by such Beneficiary . . ." It further provided:

At the death of the last surviving Beneficiary if there be no Contingent Beneficiary then living, or at the death of the last surviving Contingent Beneficiary occurring subsequently thereto, the amount retained by the Company under Option "A" will be paid to the executors, administrators or assigns of such last surviving Beneficiary or Contingent Beneficiary upon due surrender of this Policy.

Decedent made no election or designation of a contingent beneficiary. She thus remained at the time of her death, as she was at that of her father, the sole and only designated beneficiary. Upon decedent's death, the proceeds of the policy were paid by the insurance company, as it was obligated by contract to do, to the executor of her estate. Decedent by her will made no mention of the insurance policy or its proceeds but provided in a residuary clause as follows: "All the rest, residue and remainder of my estate, whether real personal or mixed, including the proceeds of the sale of the property above mentioned, I give, devise and bequeath to the Second National Bank of Danville, Illinois, in trust however, for the following uses and purposes. . . ." The insurance proceeds thus received by the executor were paid or turned over to the Second National Bank (plaintiff in the instant action), the trustee thus designated in the residuary clause of decedent's will.

The government endeavors to support the judgment upon two provisions of the [1939] Internal Revenue Code, (1) Sec. 811(a) [§2033, 1954 Code] and (2) Sec.811(f) [see §2041(a)(1), 1954 Code]. Sec 811(a), so far as now material, provides for the inclusion of the value at the time of death of all property, *etc*, "To the extent of the interest therein of the decedent at the time of his death." Sec. 811(f), entitled "Powers of Appointment," provides, so far as here material, "(1) Property with respect to which decedent exercises a general power of appointment created on or before October 21, 1942. To the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent (1) by will . . . ; but the failure to

exercise such a power or the complete release of such a power shall not be deemed an exercise thereof."

The government's main reliance is upon the first provision, that is, that the decedent at the time of her death had an interest in the insurance proceeds, not in part but to their full value. It designates the second provision, relative to the exercise by decedent of a general power of appointment, as alternative.

[In an omitted part of the opinion, the court held that the decedent did not possess a power of appointment within the meaning of §811(f) of the 1939 Code.]

We now turn to the government's first contention, that is, that the decedent had an interest in the insurance proceeds which at her death became liable to an estate tax. On this theory the government presents a more plausible argument but, even so, we do not think it is entitled to prevail. It must be kept in mind that the annuity payments of 3% per annum upon the principal amount of the insurance received by her from the time of her father's death to that of her own are not here involved. We are concerned only with the property interest which the decedent during her lifetime had in the principal amount. Her rights therein were two in number and no more, (1) the right to require the insurance company to retain in its possession during her lifetime the insurance proceeds, the income from which she was to receive in the form of a designated annuity, and (2) the right previously discussed, to nominate, in the manner which the insurance contract specified, a contingent beneficiary. The policy was not subject to surrender and we are aware of no way by which she could have required the insurance company to pay her a single dollar of this principal. And even though she had nominated a contingent beneficiary, that beneficiary would have been entitled to no part of the insurance proceeds until after decedent's death.

The government advances theories relative to decedent's control and dominion over the insurance proceeds, which possess more novelty than merit. For instance, the government in its brief states: "From the time of her father's death in 1925, the decedent possessed not only a life estate in the fund but also the remainder interest therein of which she could not be divested except by her voluntary act." Assuming she had a life estate in the fund, which we doubt, such interest was extinguished at her death. In our view, there is no basis for the claim that she possessed a "remainder interest." After the fund had been retained and employed by the insurance company for decedent's benefit during her lifetime, it vested irrevocably and was payable either to the "executors, administrators or assigns" of the decedent or to a contingent beneficiary, depending upon whether decedent during her lifetime exercised her right to select such contingent beneficiary and made such election effective in the manner provided for by the contract. The government in its brief continues: "She could sell, pledge, or assign, in whole or in part, either her life interest or her remainder interest in the fund, or both, to anyone of her own unrestricted choice, including her creditors." If this all-inclusive description of decedent's control or right over the fund means only that she could nominate a contingent beneficiary, we agree. If it means that she had any right or control over the fund other than that, we disagree. The brief continues: "She could and did dispose of her remainder interest by will." It may be true she attempted to do so but her act in that respect was, in our judgment,

futile because, for the reasons heretofore shown, it was unauthorized, she was without power to divert the fund by testamentary devise. The novelty of the argument increases as we go along. The brief further states: "In fact, the decedent possessed from the date of death of her father all of the incidents of complete ownership of the fund save only that she could not withdraw the money from the insurance company during her lifetime." It would be more logical to state that decedent during her lifetime possessed none of the incidents of ownership; in fact, she possessed no rights relative to the fund other than those which we have previously stated.

Any attempt to analyze or discuss all the cases called to our attention would unduly burden this opinion. We shall content ourselves with referring to a few of the many. In *Estate of Susie C. Haggett* v. *Commissioner*, 14 T.C. 325, the Tax Court considered a situation where decedent's incidents of ownership were far greater than in the instant case. The court stated, 14 T.C. at page 329: "The present decedent's interest in the annuity contract was that of a life beneficiary with the power to surrender the contract and receive its then cash value, and also the power to change the beneficiaries. Neither of these powers was exercised by her during her lifetime. But a mere power with respect to property is not such an interest therein as subjects it to the provisions of section 811(a) of the Internal Revenue Code."

In discussing the estate tax provision, the court, in *Y.M.C.A.* v. *Davis*, 264 U. S. 47, 50, stated: "What was being imposed here was an excise upon the transfer of an estate upon death of the owner. It was not a tax upon succession and receipt of benefits under the law or the will. It was death duties, as distinguished from a legacy or succession tax. What this law taxes is not the interest to which the legatees and devisees succeeded on death, but the interest which ceased by reason of the death."...

Helvering v. *Safe Deposit & Trust Co.*, 316 U.S. 56, is another case where there was no question as to the power of the decedent to make a testamentary disposition of property. The case presents a two-fold situation; in one the power was not exercised by the decedent and in the other it was. As to the former, the court stated, 316 U.S. at page 59: "And viewing Section 302(a) in its background of legislative, judicial, and administrative history, we cannot reach the conclusion that the words 'interest... of the decedent at the time of his death' were intended by Congress to include property subject to a general testamentary power of appointment unexercised by the decedent."

While, as previously noted, no mention was made of the insurance proceeds in decedent's will, it is true under the stipulated facts that such proceeds, together with other property, were turned over by her executor to the trustee designated in her will. Whether the executor had a right to do so is a question not before us and we think it is of no significance. If the decedent had the power by will to direct that the insurance proceeds be paid to a trustee, it would seem logical to conclude that she could have directed payment to Bill Jones, or anybody else. Can there be any rational supposition that the insurance company could have been required to recognize such a direction on the part of the decedent? And the fact is, of course, that the proceeds were paid to the executor not by reason of decedent's will but because of the contractual obligation with her

father. Any abortive attempt by decedent to make a disposition of the insurance proceeds effective after her death is not determinative of the issue for decision. The controlling factor is, as we have heretofore attempted to show and which we think is irrefutable, that the decedent was without such power. In *Estate of Rogers* v. *Commissioner*, 320 U.S. 410, 413, the court stated, "And that is precisely what the federal estate tax hits — an exercise of the privilege of directing the course of property after a man's death." Here, any attempt by decedent to exercise the privilege (power) to direct the course of the insurance proceeds after her death was of no effect; she was not possessed of power to do so.

The judgment of the district court is reversed and the cause remanded with directions that a judgment be entered in accordance with the views herein expressed.

EISENSTEIN
ARE WE READY FOR ESTATE AND GIFT TAX REVISION?

23 Taxes 316, 323–4 (1945)
(Reprinted by Permission)

There seems to be an impression that an estate tax is congenitally unable to fasten upon property which passes from one trust beneficiary to another, since the decedent has never been full-fledged owner of the property. But this is to assume on the basis of our own limited experience that the deficiencies of the *federal* estate tax must necessarily harass *every* estate tax. In short, substantial change is excluded by freezing the shortcomings of the very status quo which is questioned. However, even if the ingredients of a sturdy estate tax base are to be found in existing tax measures, little is gained by referring to our present estate tax law. For the older British estate tax, which started its career in 1894, has always had special provisions handling property settled in trust. However, as I see it, we should think things and not words. The important thing is not to search for certain so-called intrinsic characteristics or limitations of an estate tax, but to determine, as a matter of policy, the requirements of an effective and equitable estate tax, regardless of the particular scheme of disposition. An estate tax is what we make it. One need not bow to any inner compulsion of semantics.

The vital fact is that under the present federal estate tax, property which passes by outright disposition bears a far heavier tax load than property which moves along paths charted in advance by a trust. How can this condition be met? I am going to mention four possible approaches. Although these four hardly exhaust the alternatives which compete for recognition, they seem to provide a sturdy framework of reference even if individual tastes may differ quite violently.

The first possibility is to impose an additional tax upon the initial disposition in trust to compensate for the interim loss of revenue as a result of the settlement in trust. In considering this approach, it is well to remember that we are not entirely in the realm of theory. As I have already suggested, the English, unlike ourselves, were acutely conscious of the avoidance potentialities of the trust device and imposed in their original act of 1894 an additional tax — called a Settlement Duty — upon dispositions in trust. The purpose of this duty was to equalize, in rather rough fashion, the total burden, over several generations, borne

by property in trust and property passing outright. This additional duty, however, was abandoned in 1914 because it failed to attain its objective. From our own point of view, I think there are three difficulties which should be noted. In the first place, the compensatory levy might have to be so high in order to attain an equivalence in burden that it would be politically unfeasible. Second, the additional tax would fail to differentiate between different trusts on the basis of successive shifts in beneficial enjoyment. Finally, a levy upon the disposition in trust would enable all successions under outstanding trusts to escape tax. I have never been able to understand why the early bird should necessarily catch the worm when the tax laws are strengthened and improved. An initial error is hardly a remorseless excuse for creating a vested interest in the error under cover of the Constitution.

The present English law offers us a second possibility, namely, to tax the property when the beneficial enjoyment shifts from one person to another. Hence, upon the death of the life tenant, the property would be included in his gross estate. Undoubtedly this treatment of trusts is at variance with established notions for, after all, the life tenant, who has never owned the property, is accorded the status of owner at death. I will by-pass the constitutional question, although I would like to mention the Supreme Court's recent admonition that it is sufficient for estate tax purposes "that one person acquires economic interests in property through the death of another person; even though such acquisition is in part the automatic consequence of death."[1] The important question at present is one of policy — to determine the appropriate tax treatment. While the constitutional issues are obviously serious, we may worry about constitutional doctrine once we have decided what to do. It may nevertheless appear unjust to tax the life tenant as if he were owner. Tax law, however, is no exception to the rule that "the right answer usually depends on putting the right question."[2] If the crucial question is how to devise a levy which is geared to the decedent's quantum of ownership, then the English system is undoubtedly on the wrong track. If, on the other hand, the question is one of implementing the estate tax so that, regardless of the particular type of disposition, it takes the same periodic bite out of property as it moves from one generation to another, the British estate tax is clearly on the right track.

A third alternative is more modest than the English statute. Our problem would be approached from the taker's side of the transfer by imposing a supplementary accessions tax upon the remainder when it falls in. The major practical distinction between this type of tax and the English method is that the former would not aggregate the remainder together with the life tenant's individual property. The tax base would be composed entirely of the remainder out of which the tax would be paid. Dispositions in trust would still enjoy tax benefits although they could be somewhat curtailed, depending upon the rate. A supplementary accessions tax, which is essentially a modified inheritance tax, naturally raises the question of handling accessions which are not absolute in character. For example, to take a simple case, suppose the initial life estate is followed by another

[1] Whitney v. State Tax Commission, 309 U.S. 530, 538 (1940).
[2] Estate of Rogers v. Comm., 320 U.S. 410, 413 (1943).

before the remainder materializes in possession and enjoyment. The tax upon the second life estate could be determined in a variety of ways. It might be imposed upon commencement of the tenancy and be based upon the actuarial value of the interest as under an inheritance tax; it might be collected on a pay-as-you-go basis as the income was received, with a rate progression akin to that of the gift tax, or it might be computed at the termination of the tenancy, when the period of enjoyment was already a matter of history rather than prediction. The difficulties of valuation would of course increase as the contingencies became more complicated, and the complexities could easily pass beyond the recognized limitations of the art of valuation.

The valuation problems posed by a supplementary accessions tax lead very easily and naturally to the fourth possibility. Instead of imposing an accessions tax, Congress might enact a supplementary estate tax which would apply to property passing in accordance with a settlement in trust made by another. As an estate tax, the levy would avoid the valuation complexities just noted, since the tax would be laid upon the transfer of beneficial enjoyment and not upon the taker's receipt. The tax would be distinguishable from the British death duty in that the trust property would not be aggregated with the decedent's individual assets. A supplementary estate tax of this type would fit very snugly into our present system and its established concepts. It would not, however, attain the equivalence of the British system.

Note

See also Surrey, "An Introduction to Revision of the Federal Estate and Gift Taxes," 38 *Calif. L. Rev.* 1, 18–23 (1950).

The principal objections to employing the dispositive pattern of a life estate in children, remainder to grandchildren, as a device to avoid estate taxation are two.

(1) The family fortune may not be large enough to take care of the children if they are given only a life estate. Because of this drawback, the life-estate-remainder sequence is most useful in precisely those circumstances where it most reduces the tax burden—for a very large family fortune.

(2) Ordinarily the children, rather than the grandchildren, are the primary object of the grantor's solicitude. Consequently, even if the fortune is large, he may be fearful of a shrinkage in return that will squeeze the life tenants. The remedy is to give them the right to invade corpus. But if the right is unfettered, it will be a "general power of appointment" under §2041, and (if created after 1942) it will bring the property into the life tenant's estate even if he dies without exercising it. As will be seen later, however, under today's law the life tenant can be endowed with certain restricted powers to invade corpus (in the event of extraordinary medical expenses, up to $5,000 per year, *etc.*) without bringing the corpus into his gross estate. Another possibility, which may adequately protect the life tenant even though it gives him less independence, is to vest in a third person the power to advance corpus.

G.C.M 27242

Internal Revenue Service, 1952
1952–1 C.B. 160

An opinion is requested with respect to the inclusion in the gross estate of an employee of a death benefit payable under a profit-sharing and retirement plan

under which plan the employer is the sole contributor and the employee has the right to designate the beneficiary.

Under the provisions of the profit-sharing and retirement plan in the instant case, all contributions to the plan are made by the company. Each year the company transfers 15 percent of its net income to the trustee of the plan and the trustee allocates the contribution to the accounts of the eligible employees for that year on the basis of compensation and length of service of such employees. Income of the trust property and any amounts forfeited by employees by reason of discharge or termination of employment are also allocated on the same basis. Upon the death of a participating employee prior to retirement, the participating interest of such employee is paid to the beneficiary or beneficiaries designated by him or, in the event that no beneficiary was designated by the employee, to his executors or administrators. The company reserves the right to terminate or amend the plan. Upon termination, all contributions cease and the trustee is required to pay, as promptly as possible, over to the participating employees, or their beneficiaries, their participating interests. No amendment to the plan is effective (*a*) which attempts to divert the assets held by the trustee to purposes other than for the exclusive benefit of the participating employees and their beneficiaries, or (*b*) which, without his consent, affects the right of any employee whose participating interest has already become payable to him. The employer has a right to amend the plan to eliminate the provision for the payment of a death benefit to employees dying prior to the receipt of any benefits under the plan so long as the amendment does not destroy the right of an employee or his designee to receive a death benefit which had already become payable.

In *Edward J. Dimock* v. *Corwin* (19 Fed.Supp. 56, affirmed on another issue, 99 Fed.(2d) 799), the decedent, who died on June 11, 1930, was at the time of his death an employee of the Standard Oil Co. of New York. Under a pension and death benefit plan of the employer-company, the employee was entitled to designate a beneficiary who was to receive a death benefit under the plan in the event of the employee's death. The company expressly reserved the right to terminate or modify the plan at any time. However, it was expressly provided that death benefits would be paid in accordance with the plan in effect at the time of any employee's death. The Commissioner, in that case, contended that the amount of the death benefit was includible in the decedent's gross estate under section 302(a) of the Revenue Act of 1926 (which was identical with the present provisions of [§2031, 1954 Internal Revenue Code]) as property of the decedent. The court decided that the death benefit did not constitute property of the decedent under such section. Under the plan, no death benefit was payable if the designated beneficiary predeceased the employee. However, the employee was granted the right to change, at any time, the beneficiary of the death benefit. The court also determined that the act of designating the decedent's widow as the recipient of the death benefit did not constitute a transfer of property so as to bring the death benefit into the estate under section 302(c) or (d) of the Revenue Act of 1926. The court reasoned that in view of the fact that the employer expressly reserved the right to terminate or modify the plan at any time, the employee could not be said to have a right to the death benefit which would be the equivalent of property. It should be noted in connection with the *Dimock*

case that the court cited G.C.M. 17817 (C.B. 1937-1, 281) in support of its conclusions.

In G.C.M. 17817, *supra*, this office expressed the opinion that the death benefit paid by an employer to a designated beneficiary of an employee is not includible in the employee's gross estate under section 302(a) of the Revenue Act of 1926 [§2031, 1954 Code] as property of the decedent or under section 302(g) of that Act as life insurance. The plan under consideration in G.C.M. 17817 provides for the payment of prescribed death benefits upon the death of employees who at the date of death, or at the beginning of their last illness, had been in the employ of the company for 1 year or more. An employee has the right to designate the beneficiary to whom the death benefit shall be paid. The company reserved the right to terminate or modify the plan at any time but guaranteed the payment of a death benefit in accordance with the plan in effect at the date of an employee's death. This office took the position that in view of the fact that the employer-company had reserved the right to modify the plan, the employee had no contractual right to the death benefit which could be treated as property subject to valuation.

The facts in the instant case are analogous to those considered in G.C.M. 17817 and the *Dimock* case. For instance, in each case it is possible prior to the death of a participating employee for the employer to destroy the right of an employee's designee to receive the death benefit provided under the plan. However, upon reconsideration, this office is now of the opinion that the mere possibility that an employer may withdraw, prior to the death of an employee, the right of the employee's designee to receive a death benefit does not indicate an absence of a property interest of the decedent in the right to designate a beneficiary of the death benefit.

In both G.C.M. 17817 and the *Dimock* case, it was held that the presence of the possibility that the employer would withdraw the right to a death benefit rendered the interest of the employee an "expectancy" rather than "property." The term "expectancy" usually connotes the interest of an expectant heir or distributee in the property of a person prior to the latter's death. Thus, in the case of an expectant distributee, the receipt of property of another is contingent upon the death of the present owner and the ultimate testamentary disposition of his property.

On the other hand, in the instant case, as in G.C.M. 17817 and in the *Dimock* case, the right to designate the beneficiary of a death benefit may be annulled by the positive act of the source of the benefit, the employer, of withdrawing the right to designate the recipient of the death benefit, by amending the plan to eliminate any death benefits, and this contingency is terminated by the death of the holder of the right to designate, the employee. This is not similar to an "expectancy."

Accordingly, it is the opinion of this office that where an employee has the right to designate the beneficiary of a death benefit under a profit-sharing and retirement plan, the employee, at the time of his death, is in possession of such rights as constitute property within the meaning of [§2031] of the Internal Revenue Code, provided that prior to the employee's death the employer has not withdrawn the right of the employee to designate a beneficiary, and has not eliminated all death

benefits. Thus, the amount payable under the plan to the designated beneficiary is includible in the deceased employee's gross estate under section 811(a), (c), (d), and (f) of the Code.*

In view of the foregoing, G.C.M. 17817, *supra*, to the extent inconsistent with the above-stated opinion, is hereby modified, and since the decision in the *Dimock* case as to this issue was largely based upon the reasoning of G.C.M. 17817, it is recommended that as to this point the decision in the *Dimock* case should no longer be followed in the disposition of similar cases.

Note

1. Social Security benefits paid upon the death of a covered employee are not part of the gross estate, the Treasury has ruled, because:

> . . . the decedent has no control over the designation of the beneficiaries or the amounts payable to them. The beneficiaries and the amounts payable to them are fixed by the provisions of the Social Security Act, as amended, and the payments are made directly to the beneficiaries. (E.T. 18, 40-2 C.B. 285.)

Note that the Internal Revenue Service, in both G.C.M. 27242 and in this ruling regarding social security death benefits, treats the power to designate a beneficiary as critical to estate tax liability. Does this mean that if a minor dies before he is capable of making a will, his estate will not be subject to federal estate tax because he did not have an opportunity to choose his beneficiaries? If the power to designate a beneficiary is essential to estate tax liability for employee and social security death benefits, why is not that element supplied (even if the benefits are to be paid to persons selected by the employer or by Congress) by the decedent's decision to accept employment with a particular employer knowing that such death benefits will be, or are likely to be, paid?

See also Rev. Rul. 55-87, 55-1 C.B. ___, Note, 48 *Col.L.Rev.* 393 (1948); and, for cases following *Dimock* v. *Corwin*, *Estate of Stake* v. *Commissioner*, 11 T.C. 817 (1948); *Estate of Salt* v. *Commissioner*, 17 T.C. 92 (1951). For other aspects of the employee death benefit problem, see *infra*, pp. 1159-61.

In Rev Rul. 54-19, 54-1 C.B. 179, the Internal Revenue Service ruled that the estate of a decedent who died in an airplane crash did not include the executor's claim against the carrier for damages. The state wrongful death statute provided that the executor or administrator of the decedent could sue, but for the benefit of the decedent's intestate successors rather than for the benefit of his estate and legatees:

> The decedent in his lifetime never had an interest in the right of action or in the proceeds. He did not create the right, it was created by statute and vested in the persons designated in the statute. Inasmuch as the decedent had no right of action or interest in the proceeds at the time of his death, nothing "passed" from the decedent to the beneficiaries. Accordingly, the amounts recovered by the beneficiaries would not be includible in the decedent's gross estate for Federal estate tax purposes.

What if the cause of action became part of the decedent's estate? What of a claim for pain and suffering during the decedent's last hours?

2. See also *Rodiek* v. *Commissioner*, 33 B.T.A. 1020 (1936), excluding from the estate a claim against the United States for compensation for an erroneous seizure of property under the Trading with the Enemy Act, pursuant to a Senate resolution passed after the decedent's death, a proceeding was commenced in the Court of Claims, which was to report its findings to the Senate. The Tax Court said: "What that report may

* §2031, §2037 (transfers taking effect at death), §2038 (revocable transfers), and §2042 (life insurance proceeds). [Ed.]

turn out to be, no one can now foretell, and even the most favorable recommendation which may be made by that court to the Senate will be of no force to establish an enforceable legal right. The Senate will then act upon its own judgment upon a broad standard of sovereign justice, and may uncontestably refute what the Court of Claims may recommend." (33 B.T.A. at 1045–6.) What if the Senate had acted favorably before the tax proceeding was commenced but after the decedent's death? What if the resolution had been passed *before* the decedent's death?

The Internal Revenue Service has recently ruled that the right of the executor of an attorney's estate to receive payment on a *quantum meruit* basis for legal services performed by the decedent under a contingent fee contract constitutes an interest in property within the meaning of §2033. (Under state law, in the event of the death of an attorney who was employed on a contingent fee basis, his estate is ordinarily entitled to recover the reasonable value of his services if the case is terminated successfully.) Rev. Rul. 55-123, 55-1 C.B. ___. Since the right to collect on a *quantum meruit* basis arises only because of the attorney's death (and is contingent upon a successful termination of the litigation), does it come within the terms of §2033 ("property . . . to the extent of the interest therein of the decedent at the time of his death")? If it does, how can its value at the time of death be ascertained?

BULL v. UNITED STATES

Supreme Court of the United States, 1935
295 U.S. 247

Mr. Justice ROBERTS delivered the opinion of the Court.

Archibald H. Bull died February 13, 1920. He had been a member of a partnership engaged in the business of ship-brokers. The agreement of association provided that in the event a partner died the survivors should continue the business for one year subsequent to his death, and his estate should "receive the same interests, or participate in the losses to the same extent," as the deceased partner would, if living, "based on the usual method of ascertaining what the said profits or losses would be. . . . Or the estate of the deceased partner shall have the option of withdrawing his interest from the firm within thirty days after the probate of will . . . and all adjustments of profits or losses shall be made as of the date of such withdrawal." The estate's representative did not exercise the option to withdraw in thirty days, and the business was conducted until December 31, 1920, as contemplated by the agreement.

The enterprise required no capital and none was ever invested by the partners. Bull's share of profits from January 1, 1920, to the date of his death, February 13, 1920, was $24,124.20; he had no other accumulated profits and no interest in any tangible property belonging to the firm. Profits accruing to the estate for the period from the decedent's death to the end of 1920 were $212,718.79*, $200,117.90 being paid during the year, and $12,601.70 during the first two months of 1921 . . . .

1. We concur in the view of the Court of Claims that the amount received from the partnership as profits earned prior to Bull's death [$24,124.20] was income earned by him in his lifetime and taxable to him as such; and that it was also corpus of his estate and as such to be included in his gross estate for computation of estate

* There are several minor inconsistencies in the amounts as reported in the Court's opinion. [Ed.]

tax. We also agree that the sums paid his estate as profits earned after his death [$212,718.79] were not corpus but income received by his executor, and to be reckoned in computing income tax for the years 1920 and 1921. Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not. Here, however, the survivors have purchased nothing belonging to the decedent, who had made no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was therefore income and not corpus; and this is so whether we consider the executor a member of the old firm for the remainder of the year, or hold that the estate became a partner in a new association formed upon the decedent's demise.

2. A serious and difficult issue is raised by the claim that the same receipt has been made the basis of both income and estate tax, although the item cannot in the circumstances be both income and corpus; and that the alternative prayer of the petition required the court to render a judgment which would redress the illegality and injustice resulting from the erroneous inclusion of the sum in the gross estate for estate tax. The respondent presents two arguments in opposition, one addressed to the merits and the other to the bar of the statute of limitations.

On the merits it is insisted that the government was entitled to both estate tax and income tax in virtue of the right conferred on the estate by the partnership agreement and the fruits of it. The position is that, as the contract gave Bull a valuable right which passed to his estate at his death, the Commissioner correctly included it for estate tax. And the propriety of treating the share of profits paid to the estate as income is said to be equally clear. The same sum of money in different aspects may be the basis of both forms of tax. An example is found in this estate. The decedent's share of profits accrued to the date of his death was $24,124.20. This was income to him in his lifetime and his executor was bound to return it as such. But the sum was paid to the executor by the surviving partners, and thus became an asset of the estate; accordingly, the petitioner returned that amount as part of the gross estate for computation of estate tax and the Commissioner properly treated it as such.

We are told that, since the right to profits is distinct from the profits actually collected, we cannot now say more than that perhaps the Commissioner put too high a value on the contract right when he valued it as equal to the amount of profits received—$212,718.99. . . .

While, as we have said, the same sum may in different aspects be used for the computation of both an income and an estate tax, this fact will not here serve to justify the Commissioner's rulings. They were inconsistent. The identical money—not a right to receive the amount, on the one hand, and actual receipt resulting from that right on the other—was the basis of two assessments. The double taxation involved in this inconsistent treatment of that sum of money is made clear by the lower court's finding we have quoted.* The Commissioner as-

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* In a previous proceeding, the Board of Tax Appeals had held that the sum of $200,117.09 received by the estate in 1920 was taxable as income for that year. 295 U.S. at 252–3. [Ed]

sessed estate tax on the total obtained by adding $24,124.20, the decedent's share of profits earned prior to his death, and $212,718.79, the estate's share of profits earned thereafter. He treated the two items as of like quality, considered them both as capital or corpus; and viewed neither as the measure of value of a right passing from the decedent at death. No other conclusion may be drawn from the finding of the Court of Claims.

In the light of the facts it would not have been permissible to place a value of $212,718.99 or any other value on the mere right of continuance of the partnership relation inuring to Bull's estate. Had he lived, his share of profits would have been income. By the terms of the agreement his estate was to sustain precisely the same status quoad the firm as he had, in respect of profits and losses. Since the partners contributed no capital and owned no tangible property connected with the business, there is no justification for characterizing the right of a living partner to his share of earnings as part of his capital; and if the right was not capital to him, it could not be such to his estate. Let us suppose Bull had, while living, assigned his interest in the firm, with his partners' consent, to a third person for a valuable consideration, and in making return of income had valued or capitalized the right to profits which he had thus sold, had deducted such valuation from the consideration received, and returned the difference only as gain. We think the Commissioner would rightly have insisted that the entire amount received was income.

Since the firm was a personal service concern and no tangible property was involved in its transactions, if it had not been for the terms of the agreement, no accounting would have ever been made upon Bull's death for anything other than his share of profits accrued to the date of his death—$24,124 20— and this would have been the only amount to be included in his estate in connection with his membership in the firm. As respects the status after death, the form of the stipulation is significant. The declaration is that the surviving partners "are to be at liberty" to continue the business for a year, in the same relation with the deceased partner's estate as if it were in fact the decedent himself still alive and a member of the firm. His personal representative is given a veto which will prevent the continuance of the firm's business. The purpose may well have been to protect the good will of the enterprise in the interest of the survivors and to afford them a reasonable time in which to arrange for their future activities. But no sale of the decedent's interest or share in the good will can be spelled out. Indeed the government strenuously asserted, in supporting the treatment of the payments to the estate as income, that the estate sold nothing to the surviving partners; and we agree. An analogous situation would be presented if Bull had not died, but the partnership had terminated by limitation on February 13, 1920, and the agreement had provided that, if Bull's partners so desired, the relation should continue for another year. It could not successfully be contended that, in such case, Bull's share of profit for the additional year was capital.

We think there was no estate tax due in respect of the $212,718.79 paid to the executor as profits for the period subsequent to the decedent's death.

[The Court's discussion of a second issue, application of the doctrine of recoupment (*supra*, pp. 762–6), is omitted.]

McCLENNEN v. COMMISSIONER

U. S. Court of Appeals, First Circuit, 1942
131 F.2d 165

Before MAGRUDER, MAHONEY and WOODBURY, Circuit Judges.

MAGRUDER, Circuit Judge.

Placing their chief reliance upon *Bull* v. *United States*, 1935, 295 U.S. 247, the petitioners, as executors under the will of George R. Nutter, deceased, seek a review by us of a decision by the Board of Tax Appeals sustaining in part the Commissioner's determination of a deficiency in the estate tax of Mr. Nutter. The Commissioner conceded error as to one item, in respect to which the Board made appropriate adjustment in redetermining the deficiency.

George R. Nutter had been a partner in the firm of Nutter, McClennen & Fish, practising law in Boston, Massachusetts. The firm kept its accounts on the cash receipts and disbursements basis. Its receipts were derived solely from personal services. Under the partnership agreement Mr. Nutter's share of the firm's net profits was 8 per cent. The agreement also contained the following provisions

> On the retirement of a partner or on his death—the others continuing the business—the retiring partner or his estate in the case of his death shall, in addition to his percentage of net profits of the Firm received by it in cash up to the date of such death or retirement, also receive the same percentage of net profits of the Firm received by it in cash until the expiration of the eighteen (18) calendar months next after such retirement, or death, and this shall be in full of the retiring or deceasing member's interest in the capital, the assets, the receivables, the possibilities and the good will of the Firm. The continuing members shall have the right to the good will and the use of the Firm name except the deceasing or retiring member's name shall not be used without his written consent or that of his estate.
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> The present book value of the Plant, Books, *etc.*, and the Cash Capital of the Firm used to carry uncollected disbursements, *etc*, shall be furnished in accordance with the proportions of the partners' profit sharings for 1936 This will be accomplished by appropriate debits and credits on the books. These capital items are to be readjusted from time to time as profit sharing percentages change.

Mr. Nutter died on February 21, 1937. The balance sheet of the partnership, as of the date of Mr. Nutter's death, indicates the interests of the partners in the firm assets by reference to accounts described as follows· "Capital Account," $12,375, "Plant Account," $8,932.44, and "Undistributed Profits," $73,634.50. The share of the deceased in these three accounts was, respectively, $1,031.25,[1] $744.37,[1] and $6,136.21. The capital account represents the interest of the partners in a working cash balance, and the plant account represents the interest of the partners in such items as books, furniture, and other fixtures in the law office. The firm owned a lease upon its offices, ending February 28, 1939. It was found by the Board that the firm enjoyed good will, in which the decedent had an interest and to which he contributed.

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[1] These two amounts are slightly more than 8 per cent of the total capital account, and plant account, respectively. This is because under the partnership agreement E. Louise Malloch, an employee and not a partner of the firm, is entitled to receive a share in the total earnings of the firm but has no share in its "capital" or "plant" account.

At the date of Mr. Nutter's death the firm and the members thereof had rendered legal and related services for which payment had not been received. Some of such work had been completed and some had not been completed on February 21, 1937. No consideration was given to such completed and partially completed services, which had not been paid for, in computing Mr. Nutter's share, amounting to $6,136.21, of the undistributed profits of the firm at the date of death.

After the death of George R. Nutter the other partners continued the business. Eight per cent of the net profits of the firm for the 18 calendar months next after the death, computed on the basis of cash receipts and disbursements, amounted to $34,069.99, which amount was paid over to the petitioners as executors. Of this amount $28,069.46 represented 8 per cent of the net profits for the period of the year next after the death, and the remainder represented 8 per cent of the net profits for the last six months of the agreed 18 months' period.

Petitioners filed an estate tax return with the Collector of Internal Revenue at Boston, and paid the tax thereon shown to be due. On the said return they duly elected to have the property includible in the gross estate valued as of one year after decedent's death, in accordance with the method authorized by [§2032, 1954 Code, *infra*, p. 1191] The sum of $6,136.21, which had been received by the executors as representing the decedent's share of the undistributed profits as of the date of the death, was included in the estate tax return as part of the decedent's gross estate. But beyond this nothing was included on account of the value of the decedent's interest in the partnership.

In his notice of deficiency the Commissioner determined that $34,069.99 should have been included in the gross estate as the value of decedent's "interest in partnership Nutter, McClennen & Fish." The Board has upheld the Commissioner in this determination. We think the Board was right.

In the absence of a controlling agreement in the partnership articles the death of a partner dissolves the partnership. The survivors have the right and duty, with reasonable dispatch, to wind up the partnership affairs, to complete transactions begun but not then finished, to collect the accounts receivable, to pay the firm debts, to convert the remaining firm assets into cash, and to pay in cash to the partners and the legal representative of the deceased partner the net amounts shown by the accounts to be owing to each of them in respect of capital contributions and in respect of their shares of profits and surplus. The representative of a deceased partner does not succeed to any right to specific partnership property. In substance the deceased partner's interest, to which his representative succeeds, is a chose in action, a right to receive in cash the sum of money shown to be due him upon a liquidation and accounting. These substantive results may be rationalized upon a theory of the partnership "entity." *Cf.* Learned Hand, J., in *Re Samuels & Lesser*, D.C.S.D.N.Y. 1913, 207 F. 195, 198. The same substantive results are reached under the Uniform Partnership Act which, in form at least, proceeds on the aggregate theory. See Crane, "The Uniform Partnership Act—A Criticism," 28 *Harv. L. Rev.* 762 (1915). That act, which is law in Massachusetts, conceives of the partner as a "co-owner with his partners of specific partnership property holding as a tenant in partnership"; but provides that on the death of a partner "his right in specific partnership property vests in the surviving partner or partners. Another enumerated property right of a partner, "his interest in the partnership," is described as "his share of the profits and surplus, and the

same is personal property," regardless of whether the firm holds real estate or personalty or both. See Mass. G. L. (1932 Ed.) c. 108A, §§24, 25 and 26; see also §§30, 33, 37, 38(1), 40, 43.

This chose in action to which the representative of the deceased partner succeeds, the right to receive payment of a sum of money shown to be due upon a liquidation and accounting, is of course a part of the deceased partner's wealth, and includible in the decedent's gross estate for purposes of computing the estate tax by virtue of the comprehensive definition in [§§2031(a) and 2033, 1954 Code]. This is none the less true even though the net amount thus shown to be due to the estate is derived in whole or in part from past earnings or profits of the partnership resulting from personal services—profits which the decedent, if he had lived, would have had to report as income. The valuation of this chose in action might be a matter of difficulty, especially in the case of a partnership which cannot be speedily liquidated and whose accounts are complicated. Nevertheless, for estate tax purposes, the valuation must be made by the legal representatives of the deceased partner, on the basis of the best evidence available at the applicable valuation date.

In the case at bar, if there had not been the controlling provision in the partnership articles, above quoted, or if the survivors had not come to some agreement otherwise with the executors of Mr. Nutter, the survivors would have had to proceed to wind up the affairs of the partnership, to conclude all unfinished legal business on hand at the date of the death, to realize upon all of the assets of the firm, tangible or intangible, to pay the debts, to return to Mr. Nutter's estate his contribution of capital, if any, and to pay to his estate in cash the amount shown to be due in respect of his "interest in the partnership," that is, his "share of the profits and surplus," as determined upon an accounting. Among other things to be taken into account, "the earned proportion of the unfinished business" would have had "to be valued to determine the decedent's interest in the partnership assets." *Helvering* v. *Enright's Estate*, 1941, 312 U.S. 636, 641; *United States* v. *Carter*, 5th Cir., 1927, 19 F.2d 121.

To obviate the necessity of a liquidation, or to eliminate accounting difficulties [2] in determining the value of the deceased partner's interest, partners often make specific provision in the partnership articles.

Sometimes the partnership agreement merely provides for the postponement of liquidation, say, to the end of the term for which the partnership was created. Thus, a partnership agreement between A, B and C might provide that "should any partner die during the term of said co-partnership the firm shall not be dissolved thereupon, but the business shall be continued by the survivors until the expiration of said partnership term, the estate of the deceased partner to bear the same share in profits and losses as would have been received and borne by the deceased partner had he lived." Under such an agreement, if A dies, B and C do not buy out A's interest in the partnership. Unless more appears, A's executor does not become personally liable as a general partner, *Butcher* v. *Hepworth*, 1889, 115 N.Y. 328, 339, 22 N.E. 160, 163 *et seq.* Nor is A's general estate in the executor's hands liable as a partner for new debts created by B and C in

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[2] These difficulties, in the case of a law firm with a lucrative practice, were alluded to in Helvering v. Enright's Estate, 1941, 312 U.S. 636, 643.

continuing the business. *Stewart* v. *Robinson*, 1889, 115 N.Y. 328, 22 N.E. 160, 163, 5 L.R.A. 410. For the remainder of the term, A's share already embarked in the business remains in, subject to the risks of the business. It would seem not improper to describe the continuing business as now being owned by B and C as general partners, with A's estate (or A's executor as trustee under the will of A) as a limited partner therein, sharing in the profits, but not liable beyond the amount of interest already embarked in the business.

In the case just supposed, the chose in action, the right to which A's executor succeeds, would have to be included as part of the gross estate for estate tax purposes. It is a right to a fixed share of the profits of the business during the continuance of the term, plus a right to receive in cash the amount due to A's estate upon a final liquidation and accounting after the expiration of the term. This right in its entirety is an asset of A at the date of his death; and the value of this right as of the date of the death or the optional date one year later, with due discount for postponement of payment and other contingencies, would be included in computing the value of the gross estate. *Bull* v. *United States*, 1935, 295 U.S. 247, was a peculiar case on its facts and in the way the case came up; but we do not understand this case to hold that a right to receive future income payments is not "property" includible in the gross estate.[3] A similar instance is the case of a decedent who dies possessed of a bond for $1,000 payable in ten years bearing interest at 6 per cent. The bond in its entirety may be valued at par at the date of the death, and this amount will be included in the gross estate. But this valuation embraces two elements, (1) the present value of the bondholder's right to receive a principal payment of $1,000 ten years hence, and (2) the present value of the bondholder's right to receive periodic interest payments until the bond is due. If the bondholder had lived he would have had to report the interest payments as income; nevertheless, upon his death his right to receive such future income payments would be in effect included in his gross estate. So if a creditor lends a sum of money to a partnership under a contract whereby the principal sum is to be repaid at the end of ten years, and meanwhile, in lieu of a fixed rate of interest, the creditor is to receive a share of the profits, the periodic receipt of such profits would be income to the creditor; but if the creditor should die there would have to be included in his gross estate not only the right to receive future repayment of the principal but also the right to receive a share of the profits for the balance of the term of the loan. Likewise if a life insurance agent, after the termination of his agency, has a contract right to renewal commissions payable to him for services which had previously been rendered in writing policies of insurance, the subsequent receipt by him during his lifetime of such commis-

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[3] See the discussion by Mr. Justice Roberts in 295 U.S. 247, at page 256. At this point the opinion answers the argument of the Commissioner that the value of the right of the deceased partner to a share in future profits of the firm ought to be included in the gross estate, while the receipt by the executor of such future profits should be reported by the executor as income to the estate The answer given is that the identical money received by the executor "not a right to receive the amount, on the one hand, and actual receipt resulting from the right on the other—was the basis of two assessments." See also Helvering v. Enright's Estate, 1941, 312 U.S. 636, 641, in footnote 9, where the court recognizes that the right of a deceased partner in a law firm to share in fees accruing to the partnership after his death, might in the year the share became distributable "then be income to the estate, even though the value of the right to receive it was included in the estate return."

sions would no doubt be income to him, see *Helvering* v. *Eubank*, 1940, 311 U.S. 122, but it can hardly be doubted that upon his death his right to receive such future income payments would have to be included as part of his gross estate.

We have spoken of a common type of arrangement whereby liquidation of the partnership is merely postponed, the deceased partner's estate sharing in the profits meanwhile. The payment to the estate of a share of the intervening profits could in no sense be described as the purchase price for the deceased partner's interest, for the value of that interest is ultimately to be paid over to the legal representative upon a final liquidation and accounting at the end of the partnership term.

In the case at bar the partnership agreement contains another familiar arrangement, whereby no liquidation and final accounting will ever be necessary in order to satisfy the claim of the deceased partner. In place of the chose in action to which Mr. Nutter's executor would have succeeded in the absence of specific provision in the partnership articles, that is, a right to receive payment in cash of the amount shown to be due the deceased partner upon a complete liquidation and accounting, a different right is substituted, a right of the estate to receive a share of the net profits of the firm for 18 calendar months after the partner's death.

The language of the partnership agreement in the present case is couched in terms of a purchase of the deceased partner's interest. What the estate is to receive "shall be in full of the retiring or deceasing member's interest in the capital, the assets, the receivables, the possibilities and the good will of the Firm." There is to be an extinguishment of the decedent's interest in the totality of the firm assets, tangible and intangible, as they stood at the moment of death, and the interests therein of the surviving partners are to be correspondingly augmented. Decision in the estate tax case now before us does not turn on the question whether the effect of the partnership agreement may be characterized with entire accuracy as a "purchase" and "sale" of the deceased partner's interest in the partnership.

If the agreement had provided that at the expiration of 18 months after the death the deceased partner's estate shall receive $30,000 "in full of the deceased member's interest" no one could doubt that the commuted value of the right to receive this future payment of $30,000 would have to be included in valuing the decedent's gross estate. The nature of the transaction is not essentially changed if the sum to be paid is expressed in terms of a variable amount calculated by reference to a percentage of the net profits of the continuing business for a stated period. See our decisions in *Hill* v. *Commissioner*, 1 Cir., 1930, 38 F.2d 165, and in *Pope* v. *Commissioner*, 1 Cir., 1930, 39 F.2d 420, which cases were cited with approval in *Bull* v. *United States*, 1935, 295 U.S. 247, 254. Whether the payment to the estate is expressed in terms of a percentage of the net profits of the continuing business as in *Pope* v. *Commissioner*, *supra*, or in terms of an amount equal to a percentage of the net profits for the stipulated period, as in *Hill* v. *Commissioner*, *supra*, is a matter of form, not of substance. In either case the purpose of the agreement is to enable the survivors to satisfy the claim of the deceased partner and to continue the business without liquidation. Under this type of arrangement there is a clear implication in *Bull* v. *United States*, 1935, 295 U.S.

247, at page 254, that the substituted right to which the executor of the deceased partner succeeds must be included as a part of his gross estate.

In the present case the Commissioner valued Mr. Nutter's interest in the partnership at the sum of $34,069 99, which happened to be the exact amount received by the executors from the survivors as representing 8 per cent of the net profits of the partnership for the 18 calendar months after the death. There is no contention that this was an overvaluation. As bearing on the value of the right to receive 8 per cent of the net profits for such period, the Commissioner put in evidence past partnership earnings as follows·

1930	$311,215 09	1933	$343,810.80
1931	345,549.12	1934	366,881.59
1932	235,016.21	1935	405,492.26

The Board pointed out that at the optional valuation date, one year after death, the 8 per cent amounted to $28,069.46 and the contract still had six months to run. The Board said: "Certainly at the end of one year the contract was worth, at least, the amount it had already produced." Judging from this, and from the past history of the partnership's earnings, the indication then was that the contract right was worth considerably more than $34,069.99. The Board therefore concluded that the Commissioner "did not err in adding to gross estate $34,069.99." We agree.

In this case we do not have to consider any questions involving the income taxes payable by Mr. Nutter's estate or by his residuary legatee or by the surviving partners in respect of the profits made by the firm during the 18 months' period after Mr. Nutter's death. We intimate no opinion as to the many perplexing income tax problems lurking in the background. . . .

The decision of the Board of Tax Appeals is affirmed.

Note

1. The relation of the income tax to the estate tax is indeed, in Judge Magruder's phrase, "perplexing," and not only in the field of partnership settlements. Congress has intervened several times to provide a statutory framework for the resolution of these troublesome problems, but many puzzles remain. The basic provision (§ 126 of the 1939 code) was enacted in 1942; with some subsequent modifications, it appears as §691 of the 1954 Code. This provision creates a category of items which constitute "income in respect of a decedent." This term is not defined in the statute and its full reach is still unknown, but an example is a claim for unpaid wages held by the estate of a decedent who did not take the claim into income when it arose because he was on the cash basis of reporting income. Under §691, the estate must report income if it collects the claim; if it distributes the claim to a legatee, however, the income will be reported by the legatee when he collects it It is important to note that §691 creates an exception to the usual rules (a) that inherited property takes on a new basis equal to its value at the date of death (*supra*, p. 968), and (b) that property acquired by bequest, devise, or inheritance is not taxable as income to the recipient (*supra*, p. 125). Items that constitute "income in respect of a decedent" do not take on a new basis, and must be reported as income if and when collected by the estate or heir.

Section 691's method of taxing the income to the estate or the heir, depending on who collects it, was adopted in 1942 to replace the prior requirement (in force from 1934 to 1942) that such items be included (even though still uncollected) in the final income tax return of the decedent. The 1934–42 method was objectionable because it piled up in the final return many items that might be collected only gradually, especially

since the Supreme Court construed the 1934 statute very broadly in *Helvering* v. *Enright's Estate*, 312 U.S. 636 (1941).

In addition to preserving the taxable status of "income in respect of a decedent," §691 provides a correlative deduction for the federal estate tax that was paid on the item by the decedent's estate. Thus, to continue with the example of the unpaid claim for wages, the estate or recipient would have taxable income on collecting the debt from the employer, but would be allowed to deduct the estate tax attributable to its inclusion in the decedent's estate. For more on the complexities of §691, see Irell, "Income in Respect of Decedents as Affected by the 1954 Internal Revenue Code," 1955 *So. Calif. Tax. Inst.* 535 (1955); Drye, "The Taxation of a Decedent's Income," 8 *Tax L. Rev.* 201 (1953); Krieg and Buschmann, "Section 126; 'Items of Gross Income in Respect of a Decedent. . . '" 32 *Taxes* 651 (1954); Craven, "Taxation of Income of Decedents," 102 *U. of Pa. L. Rev.* 185 (1953).

The taxable year in the *Bull* case was 1920, before the enactment of the statutory scheme that is now embodied in §691. Would the case have been decided differently if the statute had provided, as it now does, that the estate or legatee might deduct, on the income tax return, an appropriate portion of the estate tax when reporting "income in respect of a decedent" on income tax return? Can the *Bull* case be reconciled with the *McClennen* case?

2. The income tax treatment of partnership arrangements like that involved in the *McClennen* case was revised in 1954. As seen *supra*, p.628, payments made in liquidation of the interest of a deceased partner are taxed as income to the estate or other successor, except to the extent that they are "made in exchange for the interest of such partner in partnership property." (The latter phrase may not include amounts paid for good will, unless provided for by the partnership agreement, or amounts paid for "unrealized receivables.") How would these rules be applied to the *McClennen* agreement? The value of the right to be paid for the decedent's interest in "partnership property" is clearly part of the estate under §2033. The rest of what the estate gets from the partnership seems, by reason of §753, to be "income in respect of a decedent." The Senate Report says (p.405–6) of §753:

> The House provision has been amended to make clear that all payments to the successor of a deceased partner coming within the provisions of section 736(a) are to be considered "income in respect of a decedent." Section 753 thus covers payments in the nature of mutual insurance as well as payments attributable to the decedent's interest in the unrealized receivables of the partnership. Thus, while a successor in interest of a decedent partner will be required to include in gross income amounts received from the partnership which are attributable to the value of the decedent's interest in unrealized fees or mutual insurance, the recipient will at the same time receive a deduction for the estate tax paid with respect to the inclusion of such rights to income in the decedent's estate.

Does this mean that the *Bull* case has been laid to rest by the 1954 Code?

3. Suppose the partnership agreement provides that the estate may continue *as a partner* for a period of time after death, receiving a share of the profits but also sharing in losses to the extent of the capital invested in the firm. Would the right to share in profits be included in the gross estate under §2033? Or is this simply a case of post-death earnings of the estate, to be treated like any other yield arising from a favorable investment of the estate's assets by the executor? Is this what occurred in the *Bull* case?

4. The estate tax return is due 15 months after death. Section 6075(a). How can the value of the partnership interest be ascertained by then if the estate is entitled to share in the profits of a partnership for a number of years thereafter?

Section B. Dower, Curtesy, and Other Marital Rights: Section 2034

Internal Revenue Code of 1954

Sec. 2034. Dower or Curtesy Interests.

The value of the gross estate shall include the value of all property (except real

property situated outside of the United States) to the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower or curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy.

Note

1. Although the 1916 Act did not specifically include dower and curtesy in the gross estate, the Treasury originally ruled that such interests were taxable under §2031(a). Art. 7, Regs. 37 (1917 ed). Several courts disagreed, although it is not entirely clear whether their conclusions rested on the broad ground that there is no "transfer" of property to the extent of the dower interest or on the narrower ground that to the extent of the dower the property was not subject to charges and administration expenses or to distribution as part of the estate, as was required by the 1916 Act, *supra,* page 966. *Randolph* v. *Craig,* 267 F. 993 (M.D. Tenn. 1920); *Schuette* v. *Bowers,* 40 F.2d 208 (2d Cir. 1930). In 1921, the Treasury amended its regulations as to estates governed by the 1916 statute to exclude dower and curtesy unless subject under local law to charges, administration expenses, and distribution as part of the estate. T.D. 3165, 23 Treas. Decs. (Internal Revenue) 659 (1921); and see Art. 14, Regs. 80 (1937 ed.).

The Revenue Act of 1918 enacted what is now §2034, the House Committee on Ways and Means explaining (H. Rept. No. 767, 65th Cong., 2d Sess., 1939–1 C.B. (Part 2) 101):

> Section 402 of this bill, which takes the place of section 202 of the original Act, has been revised so as to contain a provision specifically including in the gross estate dower, curtesy, or any estate created in lieu of dower or curtesy. The distinction between dower and curtesy interest and property passing to wife or husband by will or intestate succession is technical rather than real, at least in the consideration of the question as to whether they should be subject to estate tax The proposed amendment is for the purpose of making it clear that such interests are to be included.
>
> It was the intention of the framers of the original Act that dower, curtesy, and estates created in lieu of dower or curtesy should be included in the gross estate, and your committee believes that the Treasury Department has correctly ruled in requiring them to be so included. Since a dispute has arisen with reference to this question, your committee deems it advisable to provide specifically that these estates shall be included in the gross estate.

It has been argued that the inclusion of dower in the gross estate is unconstitutional. The argument: (a) The wife's dower interest arises as an incident of her marriage, not from her husband's death; (b) therefore, there is no "transfer" at the time of her husband's death; (c) therefore, the tax is imposed not upon a transfer but upon the surviving wife's "property"; (d) therefore, the tax is not an excise but a "direct" tax; (e) therefore, the tax violates Sections 2 and 9 of Article I of the Constitution, which require that direct taxes be apportioned among the several state according to their population. The weak links in the syllogism are of course points (a) and (b), in upholding the tax, the Court of Appeals for the Eighth Circuit said, in *Allen* v. *Henggeler,* 32 F.2d 69, 72 (1929), cert. den., 280 U.S. 594:

> . . . Giving full weight to the Nebraska court's description of the wife's interest, the facts still remain that the husband has at least the following very substantial rights in such property:
>
> He has the exclusive right of possession; the exclusive right to the income incident thereto; all of it can be taken for his debts; he has therefore the exclusive right to use it as a basis for credit; he has the right to have it all applied to the payment of his debts upon his death, as to the personal property, he has the further and exclusive right of transfer and disposition and of gift, and can likewise convey real estate if his wife is not a resident of Nebraska; he has the power to convey real estate, without his resident wife's signature, and put his purchaser into possession, and, if his wife predeceases him, the title is absolute. He has every right of ownership, save that he cannot will it without her consent; and, as to real estate with a resident wife, his deed is conditioned on him outliving her; and, perhaps, he cannot give away or dissipate property in fraud of her.

These rights of the husband are among the most valuable incidents of ownership. The right of possession and enjoyment of the income, the right to use it as a basis for credit, and the right to pay his debts with it, are most important attributes of ownership. And these are all "interests" which he enjoys in his own property, under the statutes and decisions of Nebraska and which cease at his death.

As a matter of fact, the Nebraska statutes and decisions are very much like those of many other states, and it is matter of common knowledge that a widow has much greater rights in her one-third or one-half, as the case may be, after death than she does before. Upon the death of her husband, she "comes into" her property. The very substantial rights which her husband has in the one-third cease at his death.

Accord. *Nyberg* v. *United States,* 66 Ct.Cl. 153 (Ct. Cl. 1928), cert. den., 278 U.S. 646; *Mayer* v. *Reinecke,* 130 F.2d 350 (7th Cir. 1942), cert. den., 317 U.S 684. Although the Supreme Court has never directly passed on the constitutionality of §2034, its validity is assumed in *Merrill* v. *Fahs, supra,* p.922, and follows *a fortiori* from the reasoning of *Fernandez* v. *Wiener, infra,* p.1004.

2. Suppose the decedent made provision for the surviving spouse in his will, which she accepts in lieu of dower. Is she a "purchaser" for value of the allotted share so that there is no taxable "transfer"? *Crooks* v. *Loose,* 36 F.2d 571 (8th Cir. 1929), *Meyer* v. *Reinecke, supra.*

3. *H*, pursuant to an antenuptial agreement, created an irrevocable trust in favor of *W* for her life and in his will gave her the equivalent of her dower rights less the value of the trust. The Commissioner included the value of the trust in the gross estate, arguing that §2034 "should be construed to include not only interests in lieu of dower created by statute, as that section directs, but also any interest in lieu of dower created by the decedent." The court refused to adopt this construction, as it would "extend the application of [§2034] far beyond its terms" and beyond the construction of the section in the regulations (Regs. 105, Sec. 81.14). *Estate of Byram* v. *Commissioner,* 9 T.C. 1 (1947).

4. Property transferred "in contemplation of death" (a phrase examined in detail *infra*, pp. 1040–60) is part of the gross estate, "except in case of a bona fide sale for an adequate and full consideration in money and money's worth." §2035. If *H* gives *W* \$100,000 in contemplation of death, the sum will be part of his gross estate, though the money is *W*'s absolutely—indeed, even though it has been spent—long before *H*'s death What if the transfer, though in contemplation of death, was in return for *W*'s release of her dower? Since the Revenue Act of 1932, the statute has expressly provided that a relinquishment of dower, curtesy, or similar rights shall not be considered as consideration in money or money's worth. See §2043(b), the history of which was set out in *Merrill* v. *Fahs, supra,* p. 922. See also *Empire Trust Co.* v. *Commissioner,* 94 F.2d 307 (4th Cir. 1938), *Ferguson* v. *Dickson,* 300 F. 961 (3d Cir. 1924), cert. den., 266 U.S. 628, *McCaughn* v. *Carver,* 19 F.2d 126 (3d Cir. 1927).

Section C. Community Property

DE FUNIAK
PRINCIPLES OF COMMUNITY PROPERTY

Chicago. Callaghan and Company, 1943, Sections 1, 102, 113
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§*1. In general.*

Community of property between husband and wife is that system whereby the property which the husband and wife have is common property, that is, it belongs to both halves. There are varying forms of this marital community of property

system, ranging from the general community, of which the Roman-Dutch law is an example, in which all the property of the spouses owned by each at the time of the marriage, as well as all that acquired after marriage, becomes a part of the community property; to the community only of acquests and gains during the continuance of the marriage. It is this latter or ganancial system and [sic] which came to this country from Spain which prevails in several of our American states, specifically, in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Oklahoma, Oregon, Texas and Washington. It includes the property earned or gained by onerous title by either during the union, as well as that given to both during the marital union. All property which they possess is presumed to be held and owned by them in common unless or until it is proved to be the separate property of one of them. In respect of separate property each spouse is equally capable of owning separate property, and separate property owned by either before marriage continues to constitute separate property of that spouse during marriage. Likewise, property given to one spouse alone, during marriage, is the separate property of that spouse. The community property system is marked by two essential characteristics: (1) the transmissibility of the wife's interests to her heirs, so that if the wife dies first, her heirs take the share to which she would have been entitled if she had survived; and (2) during the existence of the marital relationship the spouses are the joint owners, or partners, with respect to gains and losses. This is not to say that the husband's interest is not also transmissible to his heirs if he dies first, but the point of the essential characteristic relating to the wife is that she is placed on a basis of equality with the husband as to her ownership and rights in the community property. The essential characteristic as to the joint ownership or partnership in the acquests and gains is also particularly to be noticed. Not only are the spouses on the same plane of equality as to ownership but the matter of ownership is of primary importance, as compared with the English common law principle of giving primary importance to the technical matter of in whose name title appears.

§*102. Misconception due to administration.*

What seems to confuse legal minds trained in the English common law are the discussions by the commentators that the wife might not obtain actual possession of her half of the community property so as to "control" or manage it until the death of her husband. Applying principles of property law with which they are familiar, they are unable to understand how, by their principles, there can be "ownership" without a "control." Many lawyers trained in the common law, and viewing the matter in the light of common law concepts, seem to feel that if the husband, under the Spanish community property system, had "control," *i.e.*, the administration of the community property, he must have been the virtual owner of the property; that the wife, accordingly, was not an owner in any real sense. What they seem to fail to comprehend is that the management of the common property placed in the husband was an administrative duty only, in other words, administration of the common property, and not in any sense the equivalent of the common law "control" by the husband of the wife's property which made him virtual owner and gave him the right to appropriate its use to his own enjoyment and benefit. To enter now upon a discussion of administration of the community property would merely be duplicative of the treatment

: that subject in the latter half of this chapter. It must suffice to stress here that ısband and wife both had an ownership, each one to a half of the acquests and ıins of the marriage, an ownership that was immediate and present. The husınd's ownership, however, had as incident thereto the administration of the)mmunity. Immediately upon dissolution of the marriage, her ownership in her ılf of the community acquired the same incident of administration which the ısband's ownership had formerly had an incident thereto. However, even during ıe marriage her ownership was so full and complete that she might vigorously)ppose and seek to correct any administration by the husband that was in fraud : or prejudicial to her interest, and upon occasion the administration of the entire)mmunity property might be shifted to her. And any acts of administration were 'audulent or prejudicial as to her which deprived or tended to deprive her of the enefit and enjoyment of half the community property or to deprive her of such ılf without adequate consideration.

§113. Administration of community property.

One of the attributes common to all community property systems has been ıat the administration of the community property has been, to a greater or sser degree, placed in the hands of the husband. This has resulted from the)nsideration of the husband as the head of the family, as the one who due to :onomic and biological factors has been the member of the marital partnership .ore practiced and experienced in the acquisition and management of property. ı the Spanish system of community we find that this management and control : the community property was definitely placed in the hands of the husband, the business agent of a form of partnership, to the extent that he had the)wer of alienation of it during marriage without the necessity of the consent or)nveyance of the wife, subject to the condition that his alienation was not valid it was proven to be in fraud or injury of the wife's rights. His right to manage ıd dispose of the community property could only be exercised, however, in ıdeavors to preserve or use it for their common benefit. He could not dispose of for his own exclusive benefit, dispose of it for inadequate consideration, or :herwise deal with it in a manner indicative by its very nature of an express · implied intent to prejudice the rights of the wife. While the wife's interest as described as *in habitu* or passive, it was passive only so long as the husband lministered wisely and not in prejudice of her rights. Immediately that he olated his administrative duties, her interest might be most vigorously enforced ıd protected. But even when the husband was administering wisely, it must not : thought that the wife was wholly without voice She might object to a pro)sed plan of action by the husband and agree that she was not to have any part erein, either as to sharing the profits or bearing the burdens.

In our community property states the management and control of the comunity property has generally been left in the hands of the husband as the business :ad or managing agent of the marital partnership, but the statutes of the several ıtes, in providing as to the management and control, frequently differ in extent ıd frequently add qualifications, limitations or exceptions to the right of control ıd management on the part of the husband. The statutes should at all times be :amined, but it may be remarked generally that in the main they give the hus.nd the administrative control of the community personal property, with the

like power of disposition (other than testamentary) as he has of his separate estate; and give him the administrative control of the community real property, but with the condition that the husband and wife must both join in the execution and acknowledgment of any instrument by which it is sought to convey, transfer or encumber it. In some of the states, however, the husband has the same power to dispose of the community realty as he does of the community personalty without the joinder of the wife, except where homestead property is involved. . . .*

EISENSTEIN
ESTATE TAXES AND THE HIGHER LEARNING OF THE SUPREME COURT

3 Tax L. Rev. 395, 538–540 (1948)
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Community property has been defined as consisting of "things in which substantial interests" of husband and wife "simultaneously exist and demand protection." Generally speaking, it embraces the acquisitions attributable to the economic activities of each following their marriage. Upon peering inside the system, we discover that the "community is a partnership which begins only at its end" when the marriage dissolves. The language of the system may treat husband and wife as equals; the practicalities of the system frankly discriminate in the husband's favor. If the discrimination ceased, we are told, the community would be "inept and valueless to both parties" and "the whole fabric" of the system would come apart. While the community exists, the husband is its "head and master and administrator." As regards personal property, he ordinarily has a free hand except that he may not make gifts to others or, as it is sometimes vaguely put, he may not "defraud" his wife. According to Mr. Justice White, he may indulge in "extravagant, or even reckless," expenditures; and according to Mr. Justice Holmes, who relied on Mr. Justice White, he may indulge in "debauchery." As regards real property, the husband as a rule is additionally confined since he may not sell or mortgage without the wife's written consent. We may justly say that from the viewpoint of legal prowess, "the wife's role is essentially that of a back-seat driver who may carp and criticize, but may not take the wheel." The wife is finally allowed to drive when the marriage finally ceases. Upon the death of either, one half of the property belongs to the survivor and the other half is disposable by the decedent. . . .

Neither husband nor wife under the community property system enjoys precisely as much dominion as a married owner under the common law system. But the husband's dominion is far closer than the wife's to the attributes of common law ownership. Or, stating the matter less charitably, until the community ends the wife's dominion is scarcely distinguishable from a wife's anticipated enjoyment of her husband's property following his death. The wife in a community property state may veto a disposition of realty, but the wife in a common law state may be equally obstreperous by virtue of her dower interest. Of the two, the

* See also de Funiak, "A Review in Brief of Principles of Community Property," 32 *Ky. L. J.* 63 (1943).

former has barely more to say about personalty, but the difference rarely affects the husband's power to spend as he chooses. In a community property state the husband's will cannot deprive the wife of one half of the assets. In many common law states, however, the wife has a right of succession which is also beyond testamentary reach of a displeased or ungrateful husband. The only significant difference between the interests of the two ladies is that a wife may bequeath one half of the community property if she predeceases her husband. This inroad upon his dominion seems strange by common law standards, but it aptly indicates that the wife's rights "are dormant during the marriage" and "reveal themselves" only when the marriage ceases.

Note

1. Until 1942, the estate tax statutes eschewed mention of community property, and it was early ruled by the Attorney General that only one-half of the community property need be included in the estate of the spouse who died first. T.D 3138, 23 Treas. Decs. (Internal Revenue) 238 (1921); T.D 2450, 19 Treas. Decs. (Internal Revenue) 38 (1917). See also *Poe* v. *Seaborn, supra*, p. 281.

The states embraced by these rulings were Arizona, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. all the "original" community property states except California. California, after a bewildering succession of attacks and repulses, finally joined the other community property states by amending its civil code in 1927 to provide that husband and wife have in community property "present, existing, and equal interests under the management and control of the husband." Paul, *Federal Estate and Gift Taxation*, Section 4.11 (1942). Community property acquired before 1927 was not affected by the amendment, however, and must be included in full in the husband's estate (if he predeceases his wife), the wife's interest being treated as a statutory substitute for dower taxable in the husband's estate under §§2031 and 2034.

2. In 1942, there was added to the 1939 Code §811(e)(2), which (until its repeal in 1948) required the inclusion of property.

> To the extent of the interest therein held as community property by the decedent and surviving spouse under the law of any State, Territory, or possession of the United States, or any foreign country, except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse. In no case shall such interest included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition.

Thus, in the typical case where the source of the community property was the husband's earnings, it would all be part of his estate if he died first, whereas if his wife was the first to die, one-half (the part subject to her power of testamentary disposition) would be included in her estate. Congress' reasons for this sharp break with the past are set out in the concurring opinion of Mr. Justice Douglas in *Fernandez* v. *Wiener, infra.*

BRIEF OF ATTORNEYS GENERAL OF CALIFORNIA, ARIZONA, IDAHO, LOUISIANA, NEVADA, NEW MEXICO, TEXAS, AND WASHINGTON, AS AMICI CURIAE, IN FERNANDEZ v. WIENER

Pages 62, 67–69, 71–72

Through the researches of the French and the American scholar, confirmed in their general points of view by the leading historians in so far as they deal with

this subject matter, we are enabled to trace the decline and extinction of the Anglo Saxon community laws or customs, and their replacement by an imported system, an "alien intruder," sponsored by "nobles" and based upon "the law for the great." Looking backward some eleven hundred years, we trace the origins of the common law system to the fact that Scandinavian pirates, descending on the coasts of France, adapted to their use a code of marital property laws deemed appropriate to the daughters of the vanquished. Through the conquest of England two hundred years later, the Normans imposed this law and their own particular concepts of what is appropriate for a feudal society upon the great English people. Now, by ironic coincidence, when the people that walked in the darkness of tyranny have seen the great light of liberty, this Court is asked to fasten upon the people of the United States a system of marital property rights originating in the low regard of the conqueror for the conquered, in its essence, as the French historian says, upon the relationship of master and slave.

The plain fact is that except for the wife's retention of ownership of her own separate property—a point we are not concerned with here—the common law states are still living in pre-Revolutionary times in so far as property acquired by the joint labor and sacrifice of the spouses is concerned. Whatever its statutory ameliorations, the common law still treats the wife as an inferior, not as a partner or a contributor of services having economic worth. Observing the discrimination to which the common law still subjects women; the economic insecurity with which it still holds them in bondage, the right of disposition of property acquired through common enterprise which it parsimoniously withholds—we may paraphrase, but with irony, the observation already quoted . . . of a learned commentator whose admiration seems to have been easily evoked: "So great a favorite is the female sex of the laws" of the United States!

The Alternatives Preserved

Fundamentally, the question is whether the law of the Normans shall prevail. To their avarice and cupidity, of which the French historian speaks . . . and to which the common law states are indebted for their system of marital property rights, Congress has given countenance and authority in certifying as the preferable, indeed as the exclusive system, that one which says in effect that all property acquired after marriage is acquired by the husband "through his own efforts," and "is regarded as belonging entirely to the husband." In effect, Congress has said that as to marital property acquired through their labor and sacrifice, women have, and can be given, no rights which the laws of the United States are bound to respect, thus giving practical application as a principle to a statement made by this Court as a matter of historic fact, affecting other members of the human race, likewise the objects of immemorial injustice (*Dred Scott* v. *Sandford,* 19 How. 393, 407, 15 L.Ed. 691).

The present cases present on the one side the property system favored by moralists and sages, a heritage of the great free peoples, other than Britons, who were deprived of it through no fault of their own; on the other, that inherited from Scandinavian brigands, sanctified by custom until its crudities have become obscure. This Court now has the opportunity to say whether the older and more civilized institution can continue to exist in competition with a system based on the primitive common law concept that women are inferior beings, entitled only to a subordinate place in the social order.

At a time [1945] when, not only in the homes of the nation, but in its factories and even in its services auxiliary to the military and naval power, women have been and are doing their full share to keep the world a decent place for civilized men to live in, an attempt by Congress, invading state authority, to say that no state can confer property rights on women which Congress is bound to respect, seems particularly lacking in grace and timeliness. This Court, we respectfully submit, has bound itself by no precedents which might prove embarrassing to it in reaching a result consonant with the ideal of social justice—in fact, as we have pointed out. . . , the Court's own decisions fully recognize every principle which the community property states need to establish in order to prevail.

FERNANDEZ v. WIENER

Supreme Court of the United States, 1945
326 U.S. 340

MR. CHIEF JUSTICE STONE delivered the opinion of the Court.

In this case the Commissioner of Internal Revenue, proceeding under §811(e)(2) of the [1939] Internal Revenue Code, as amended by §402 of the Revenue Act of 1942, 56 Stat. 798, has levied an estate tax on the termination of the marital community by the death of the husband, a domiciled resident of Louisiana, the tax being measured by the value of the entire community property. . . .

The principal questions for decision are (1) whether the power asserted by the statute, to tax the entire community interest, is within the taxing power of the United States; (2) whether the tax infringes the due process clause of the Fifth Amendment; (3) whether the taxing statute contravenes the command of Article I, §8 of the Constitution that "excises shall be uniform throughout the United States"; (4) whether the tax so far as it is measured by the surviving wife's share of the community property, is a direct tax, invalid because not apportioned as required by Article I, §8 of the Constitution; and (5) whether the tax invades the powers reserved to the states by the Tenth Amendment. . . .

The facts as found by the district court are not in dispute. In 1907, decedent, a resident of Louisiana, married a Louisiana resident with whom he lived in that state until his death, his wife surviving. During the marriage he carried on in Louisiana various kinds of business. With the exception of certain real estate located in Mississippi, all the property of decedent at the time of his death was held in ownership by the marital community which existed between him and his wife. At no time during the existence of the community was the wife gainfully employed outside the household, nor did she receive from any one any salary or other compensation for personal services, nor was any part of the community property derived originally from any separate property of her own. Decedent, having by his will constituted appellees his sole heirs, and having no debts of consequence, no administration was had on his estate, and appellees were by judgment of the probate court placed in possession of all decedent's property.

Appellees filed the federal estate tax return, in which they reported only one-half of the net value of the community property as subject to the tax. . . . The Commissioner assessed a deficiency in estate tax based upon appellee's failure to

include in the gross estate, subject to tax, the entire value of all the community property, . . . Appellees paid the deficiency and, following rejection of their claim for refund, brought the present suit to recover the amount of the deficiency payment which has resulted in the judgment in their favor.

Section 402 of the Revenue Act of 1942 amended §811(e), of the [1939] Internal Revenue Code, so as to include in the gross estate of decedent, subject to the estate tax:

(2) Community Interests.—To the extent of the interest therein held as community property by the decedent and surviving spouse under the law of any State . . . of the United States, . . . except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse. In no case shall such interest included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition.

The revenue laws make no provision for the distribution of the burden of the tax beyond providing that the tax shall be a lien on all of the property included in the decedent's gross estate. [§6324(a), 1954 Code.] See *Detroit Bank* v. *United States*, 317 U.S. 329, 331–333. Section [2205, 1954 Code] contemplates that the tax "be paid out of the [taxable] estate before its distribution," unless otherwise directed by decedent's will. Although the share of the surviving spouse is subject to the lien and the tax must be paid out of the estate as a whole, the federal statute leaves it to the states to determine how the tax burden shall be distributed among those who share in the taxed estate. See *Riggs* v. *Del Drago*, 317 U.S. 95.

Appellees' argument is in substance that the nature of community property is such that husband and wife each has, by virtue of the establishment of their marital community, and from its beginning, a present half interest in such property; that the death of either effects no transfer or relinquishment of any interest in the property other than that of the half share which the decedent had before his death; and that the survivor in consequence of the death of the other spouse acquires no new or different interest in the property, but only retains the half share he or she had prior to the death of the other spouse. From this appellees conclude that the death of either spouse is not an event which in any case can bring more than one-half of the community property within the reach of the power to "lay and collect . . . imposts and excises" conferred on Congress by Article I, §8 of the Constitution, and that the present amendment taxing the entire value of the community property on the death of either spouse is a denial of due process because the death of neither operates to transfer, relinquish or enlarge any legal or economic interest in the property of the other spouse. Hence it is said that the statute infringes due process by adding to the concededly valid tax on the decedent's half share a further tax measured by the one-half interest of the surviving spouse. Further, it is urged in support of the due process contention, that the statute arbitrarily and capriciously invents different rules of taxation whose alternative application is governed by a single consideration, namely, which will yield the greater tax; and that the statute creates a presumption contrary to state law, and having no rational basis in fact, that the entire community is owned or economically attributable to the spouse first to die. It is also argued that even if Congress could validly impose the tax where, as here, the husband is first to die, there is no basis for the tax where the wife dies first, and that since the statute

purports to apply in either case, and is not separable, it cannot be validly applied in this.

It is also contended that the tax is not uniform as required by Article I, §8, Clause 1 of the Constitution, because the joint interests of husband and wife in community property states are taxed according to a different and more onerous standard than is applied to comparable joint interests, and specifically to tenancies in common and limited partnerships, created under the laws of other states in which the presumption is not applied; and because the statute disregards for purposes of taxation the property laws of the community property states, while recognizing the property laws of other states for those purposes.

It is said too that the levy is a direct tax, invalid because not apportioned (Article I, §9, Clause 4 of the Constitution), insofar as it contemplates collection of part of the tax out of the wife's half of the community property, since, it is said, there is no excisable event touching her property on her husband's death and the tax collected out of her property is in effect a direct tax upon it. And finally the tax is said to invade the powers reserved to the states by the Tenth Amendment, to determine property relationships within their borders.

The merits of these contentions cannot be accurately appraised without some inquiry as to the nature of respective spouses' community property interests as defined by Louisiana law. . . .

By the law of Louisiana, every marital status subject to the laws of the state superinduces a partnership or community of the spouses with respect to property in the state acquired during the life of the community, unless there be at the time of the marriage a stipulation to the contrary. All earnings and all property acquired by the husband or wife during the life of the community become community property, with certain limited exceptions not here involved, and which need not be detailed further than to say that the spouses can acquire some separate property during marriage. It is said that all property acquired by the spouses during the marriage which falls into the community is "due to the joint or common efforts, labor, industry, economy, and sacrifices of the husband and wife," and that for this reason the husband and wife each has at all times an equal present interest in an undivided half of the whole community. The management of the community is entrusted to the exclusive control of the husband, and he may deal with and dispose of community property with no liability to account to the wife so long as the community continues. The rule is, however, that the husband may not give away any of the immovables, nor a quota of the movables, nor may he fraudulently make any alienation of property "to injure his wife."

So long as the community continues, the wife has no control over community property. She may not give it away, nor sell it, and in general, may not bind it for the payment of her debts. But upon the termination of the community, she, her heirs, or other designees receive in full possession and enjoyment one-half in value of the total community assets subject to the payment of community debts. This right so to receive one-half is indefeasible, and if she die first, her heirs or legatees take her half-share to the exclusion of the husband; if the husband die first, his half passes to his heirs or as he has directed, and the other half is the wife's.

Examination of the legislative history of the challenged statute, as disclosed by the Committee Hearings and Reports and the Congressional debates, can leave no

doubt that the purpose of Congress in enacting it was the elimination of what was believed to be an unequal distribution of the tax burdens of estate taxes which led Congress to apply to community property the principles of death taxes which it had already applied to other forms of joint ownership, on the death of either of the joint owners. The Report of the House Committee recommending the adoption of the amendment to §811 of the [1939] Internal Revenue Code pointed out the preferential treatment accorded by the federal estate tax laws to community property. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 35 to 37, 160.

There is no dispute as to the construction or operation of the provisions of the statute. Appellees do not deny that the Commissioner correctly applied the statute and correctly computed the tax if the statute is valid. Here, as will presently appear, there is no basis for saying that the statute, either in its purpose or in its practical effect, operates to regulate matters whose regulation the Constitution reserved to the states. It is a revenue measure enacted in the exercise of the federal power to lay and collect an excise. Congress has a wide latitude in the selection of objects of taxation, *Brushaber* v. *Union Pacific R. Co.*, 240 U.S. 1, 12; *Steward Machine Co.* v *Davis*, 301 U.S. 548, 581, and even under the equal protection clause of the Fourteenth Amendment, which was not included in the Fifth, the states may distinguish, for purposes of transfer taxes, between property which has borne its fair share of the tax burdens and similar or like property passing to the same class of beneficiaries which has not. *Watson* v. *State Comptroller*, 254 U.S. 122. Hence we are concerned only with the power of Congress to enact the tax.

It is true that the estate tax as originally devised and constitutionally supported was a tax upon transfers. *Knowlton* v. *Moore*, 178 U.S. 41; *Y.M.C.A.* v. *Davis*, 264 U.S. 47, 50. But the power of Congress to impose death taxes is not limited to the taxation of transfers at death. It extends to the creation, exercise, acquision, or relinquishment of any power or legal privilege which is incident to the ownership of property, and when any of these is occasioned by death, it may as readily be the subject of the federal tax as the transfer of the property at death. See *Bromley* v. *McCaughn*, 280 U.S. 124, 135 *et seq.**

Congress may tax real estate or chattels if the tax is apportioned, and without apportionment it may lay an excise upon a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property. *Bromley* v. *McCaughn*, *supra; Burnet* v. *Wells*, 289 U.S. 670, 678; *cf. Nashville, C.&St.L.R.Co.* v. *Wallace*, 288 U.S. 249, 267–8; *Henneford* v. *Silas Mason Co.*, 300 U.S. 577, 582. The power to tax the whole necessarily embraces the power to tax any of its incidents or the use or enjoyment of them. If the property itself may constitutionally be taxed, obviously it is competent to tax the use of it, *Hylton* v. *United States*, 3 Dall. 171; *Billings* v. *United States*, 232 U.S. 261, or the sale of it, *Nicol* v. *Ames*, 173 U.S. 509; *Thomas* v. *United States*, 192 U.S. 363, 370, or the gift of it, *Bromley* v. *McCaughn*, *supra.* It may tax the exercise, non-exercise, or relinquishment of a power of disposition of property, where other important indicia of ownership are lacking. *Saltonstall* v. *Saltonstall*, 276 U.S. 260; *Chase National Bank* v. *United States*, 278 U.S. 327;

**Supra*, p. 908. [Ed.]

Estate of Rogers v. *Commissioner*, 320 U.S. 410; *cf. Graves* v. *Schmidlapp*, 315 U.S. 657 with §811(d)(f) of the [1939] Internal Revenue Code.

If the gift of property may be taxed, we cannot say that there is any want of constitutional power to tax the receipt of it, whether as the result of inheritance, *Stebbins* v. *Riley*, 268 U.S. 137, or otherwise, whatever name may be given to the tax, and even though the right to receive it, as distinguished from its actual receipt and possession at a future date, antedated the statute. Receipt in possession and enjoyment is as much a taxable occasion within the reach of the federal taxing power as the enjoyment of any other incident of property. The taking possession of inherited property is one of the most ancient subjects of taxation known to the law. Such taxes existed on the European Continent and in England prior to the adoption of our Constitution.

It is upon these principles that this Court has consistently sustained the application of estate taxes upon the death of one of the joint owners to property held in joint ownership, measured by the full value of the property so held. We upheld a like tax when applied to tenancies by the entirety in *Tyler* v. *United States*, 281 U.S. 497; *Third National Bank & Trust Co.* v. *White*, 287 U.S. 577, and to property held in joint tenancy in *United States* v. *Jacobs* * and *Dimock* v. *Corwin* (companion cases), 306 U.S. 363.

Decision in these cases was not rested, as appellees argue, on the ground that the tax was imposed on a gift made by the husband, who had created the tenancy, viewed as a substitute for a testamentary transfer, or on any event which antedated the death of one of the joint owners. Instead, as we said in *Whitney* v. *Tax Commission*, 309 U.S. 530, 539, "the emphasis in these cases [was] on the practical effect of death in bringing about a shift in economic interest, and the power of the legislature to fasten on that shift as the occasion for a tax." We pointed out in *Tyler* v. *United States, supra*, 503, 504, that the use, possession, and enjoyment of the joint property which was joint before the death was thereby made exclusive in the survivor, and thus constituted a "definite accession to the property rights" of the survivor. These circumstances were thought sufficient to make valid the inclusion of the property in the gross estate which forms the primary basis for the measurement of the tax. And in *United States* v. *Jacobs, supra*, this Court sustained the tax, assailed on due process grounds, when applied to a joint tenancy created before the enactment of the taxing statute. We said, 306 U.S. at 371, that the subject of the tax was not the gift to the wife made by the husband's creation of the joint tenancy for himself and wife, but the change in possession and enjoyment of the entire property, occasioned by the death of one of the joint tenants, and that the tax was appropriately measured by the value of the entire property. "Under the statute the death of decedent is the event in respect of which the tax is laid. It is the existence of the joint tenancy at that time, and not its creation at the earlier date, which furnishes the basis for the tax." *Griswold* v. *Helvering*, 290 U.S. 56, 58. Compare *Saltonstall* v. *Saltonstall, supra*, 271.

Similarly, a tax upon the termination by death of a power to dispose of property, created before the enactment of a tax statute, does not offend due process, *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339, nor does a tax upon the

* *Infra*, p. 1027. [Ed.]

receipt of income which was earned and due before the enactment of the taxing statute. *Brushaber* v. *Union Pacific R. Co., supra,* 20; *Lynch* v. *Hornby,* 247 U.S. 339, 343; *Taft* v. *Bowers,* 278 U.S. 470, 483, 484, *Cooper* v. *United States,* 280 U.S. 409, 411. It is the receipt in possession or enjoyment of the proceeds of a right previously acquired and vested upon which the tax is laid. Such was deemed to be the taxable event under our earlier death taxes. *Clapp* v. *Mason,* 94 U.S. 589, *Vanderbilt* v. *Eidman,* 196 U.S. 480. And see *Moffitt* v. *Kelly, supra.*

With these general principles in mind, we turn to their application to federal death taxes laid with respect to the interests in community property. As we have seen, the death of the husband of the Louisiana marital community not only operates to transfer his rights in his share of the community to his heirs or those taking under his will. It terminates his expansive and sometimes profitable control over the wife's share, and for the first time brings her half of the property into her full and exclusive possession, control and enjoyment. The cessation of these extensive powers of the husband, even though they were powers over property which he never "owned," and the establishment in the wife of new powers of control over her share, though it was always hers, furnish appropriate occasions for the imposition of an excise tax.

Similarly, with the death of the wife, her title or ownership in her share of the community property ends, and passes to her heirs or other appointees. More than this, her death, by ending the marital community, liberates her husband's share from the restrictions which the existence of the community had placed upon his control of it. He acquires by her death, the right to have his share of the community separated from hers by partition, and to hold it free of all controls. He obtains, for the first time, the right to give away his immovables, and the right to give away his movables as a whole or by a fraction of the whole. Here too, the wife's death brings into being a new set of relationships with respect to his share of the community as well as hers, among which are new powers of control and disposition which are proper subjects of an excise tax measured by the value of his share. And while we do not rest decision on the point, it is of some significance that this shift of legal relationships effects a shift in point of economic substance. The precept that the wife is equal co-owner with her husband of community property undoubtedly calls into play within the marital relationship personal and psychological forces which have great importance in the practical determination of how community property shall be managed by the husband. Though it may be impossible fully to translate these imponderables into legal rules, the death of the wife undoubtedly brings, in every practical aspect, greater freedom to the husband in his disposition of that share of community property which is technically his, than is to be gathered solely from a reading of statutes and case law.

This redistribution of powers and restrictions upon power is brought about by death notwithstanding that the rights in the property subject to these powers and restrictions were in every sense "vested" from the moment the community began. It is enough that death brings about changes in the legal and economic relationships to the property taxed, and the earlier certainty that those changes would occur does not impair the legislative power to recognize them, and to levy a tax on the happening of the event which was their generating source. . . .

What we have said of the nature and incidence of the tax on community prop-

erty in large measure disposes of the various other contentions of appellees. Since the levy is an excise and not a property tax, the case is not one of taking the survivor's property to pay the tax on decedent's estate. As the tax is upon the surrender of old incidents of property by the decedent and the acquisition of new by the survivor, it is appropriately measured by the value of the property to which these incidents attach. The tax burden thus laid is not so unrelated to the privileges enjoyed by the taxpayers who are owners of the property affected that it can be said to be an arbitrary exercise of the taxing power. *Milliken* v. *United States*, 283 U.S. 15; *Burnet* v. *Wells*, *supra*, 678–9. Compare *Saltonstall* v. *Saltonstall*, *supra*. While it may generally be true, as appellees argue, that neither the husband nor wife gains any over-all financial advantage when the other dies, it suffices that the decedent loses and the survivor acquires, with respect to the property taxed, substantial rights of enjoyment and control which may be of value. Liability to the tax, in order to avoid constitutional objection, does not have to rest upon the enjoyment by the taxpayer of all the privileges and benefits of the most favored owner at a given time and place. *Corliss* v. *Bowers*, 281 U.S. 376; *Reinecke* v. *Smith*, 289 U.S. 172, *cf*. *Burnet* v. *Guggenheim*, 288 U.S. 280.

We find no basis for the contention that the tax is arbitrary and capricious because it taxes transfers at death and also the shifting at death of particular incidents of property. Congress is free to tax either or both, and here it has taxed both, as it may constitutionally do, in order to accomplish "the purposes and policy of taxation" to protect the revenue and avoid an unequal distribution of the tax burden. *Watson* v. *State Comptroller*, *supra*.

Even if it could be thought to affect the constitutionality of the taxing statute, it is plain that the statute does not depend for its operation upon any presumption that the entire community property is owned or economically attributable to the spouse first to die. Save as the statute itself grants an exemption by such attribution, so far as the community property "may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse," the tax is laid without regard to the economic source of the community property. Apart from the exemption, it is, as we have seen, the shifting at death of the incidents of the property, regardless of origin, which is the subject of the tax.

The present statute, which was enacted in order to secure a more equitable distribution of the burden of federal death taxes, is assailed because the tax is lacking in uniformity. But the uniformity in excise taxes exacted by the Constitution is geographical uniformity, not uniformity of intrinsic equality and operation. *Knowlton* v. *Moore*, *supra*, 83–109. The Constitution does not command that a tax "have an equal effect in each State," *id*. p. 104. It has long been settled that within the meaning of the uniformity requirement a "tax is uniform when it operates with the same force and effect in every place where the subject of it is found." *Head Money Cases*, 112 U.S. 580, 594. See also *LaBelle Iron Works* v. *United States*, 256 U.S. 377, 392–3; *Bromley* v. *McCaughn*, *supra*, 138; *Steward Machine Co*. v. *Davis*, *supra*, 583.

The amendment taxing community property interests is applicable throughout the territory of the United States wherever such interests may be found. There is no lack of geographical uniformity because in some states they are not found.

For a taxing statute does not fall short of the prescribed uniformity because its operation and incidence may be affected by differences in state laws. *Phillips* v. *Commissioner*, 283 U.S. 589, 602; *Riggs* v. *Del Drago, supra*, 102. "Differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity" in the constitutional sense. *Poe* v. *Seaborn, supra*, 117–8.

Appellees suggest that interests in tenancies in common and limited partnerships are very like interests in community property, and that if the tax is to be uniform, the one cannot be taxed unless the others are also. But even if it be as appellees argue, that common law family partnership or other arrangements with different names can be so devised that the marital relationship is attended by the same powers and restrictions as those derived from the laws of the community property states, and that they are differently or more lightly taxed than community property interests, we find no lack of uniformity in the constitutional sense The present amendment is geographically uniform in its application to the only subject of which it treats, community property interests, and it levies in every state an identical tax upon the subject matter included within its terms — defined property interests created by state law, having a common historical origin, a common name, and constituting a universally recognized distinct class of property interests.

There can be no doubt that the selection of such a class for taxation would not offend against the Fifth Amendment, or even the Fourteenth, merely because it did not attempt to reach casual arrangements resulting from individual agreements. Taxes must be laid by general rules. . . . Considerations of practical administrative convenience and cost in the administration of tax laws afford adequate grounds for imposing a tax on a well recognized and defined class, without attempting to extend it so as to embrace a penumbra of special and more or less casual interests which in each case may or may not resemble the taxed class. . . .

An excise tax, which the Constitution requires to be uniform, laid upon the shifting at death of some of the incidents of property, could hardly be thought to be a direct tax which must be apportioned. See *Bromley* v. *McCaughn, supra*, 138. The contention that such a tax is direct because measured by the property whose incidents are shifted at death, was rejected in *Bromley* v. *McCaughn, supra*, and in *Tyler* v. *United States, supra*, 501–4, and *Phillips* v. *Dime Trust Co.*, 284 U.S. 160, 165. A tax imposed upon the exercise of some of the numerous rights of property is clearly distinguishable from a direct tax, which falls upon the owner merely because he is owner, regardless of his use or disposition of the property. "The persistence of this distinction and the justification for it rest upon the historic fact that [excise] taxes of this type were not understood to be direct taxes when the Constitution was adopted and, as well, upon the reluctance of this Court to enlarge, by construction, limitations upon the sovereign power of taxation by Article I, §8, so vital to the maintenance of the national government." *Bromley* v. *McCaughn, supra*, 137.

The Tenth Amendment does not operate as a limitation upon the powers, expressed or implied, delegated to the national government. *United States* v. *Darby*, 312 U.S. 100, 123–4. The amendment has clearly placed no restriction upon the power delegated to the national government to lay an excise tax qua tax. Undoubtedly every tax which lays its burden on some and not others may have

an incidental regulatory effect. But since that is an inseparable concomitant of the power to tax, the incidental regulatory effect of the tax is embraced within the power to lay it. It has long been settled that an Act of Congress which on its face purports to be an exercise of the taxing power, is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed. In such a case it is not within the province of courts to inquire into the unexpressed purposes or motives which may have moved Congress to exercise a power constitutionally conferred upon it. *Sonzinsky* v. *United States*, 300 U.S. 506, 513–514, and cases cited.

We conclude that the tax here laid with respect to the community property infringes no constitutional provision. . . .

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

MR. JUSTICE DOUGLAS, concurring.

Prior to the Revenue Act of 1942 there was a great lack of uniformity among the States in the incidence of the federal estate tax. In most of the States the accumulations of the husband (who typically is the bread-winner) were taxed in their entirety on his death. In the community property states the tax generally reached only half of the accumulations because of the theory that they were the product of the wife's as well as of the husband's activities. It was this disparity which Congress sought to eliminate. As stated in the House Report (H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 35–37),

> For the purpose of Federal estate taxation, husband and wife living in community-property States enjoy a preferential treatment over those living in non-community-property States. This is due to the fact that all of the property acquired by the husband after marriage, through his own efforts, in a community-property State is treated as if one-half belonged to the wife. In non-community-property States, all such property is regarded as belonging entirely to the husband.

There are contained in the Report tables showing the difference in the amount of the federal estate tax in the community property States and in other States, after which the Committee makes the following comment:

> . . . In some instances there is an entire exemption from the Federal estate tax for the reason that the omission of one-half of the community property reduces the husband's net estate below the minimum exemption of $40,000.* Moreover, this halving of community property greatly reduces the estate tax because of the progressive rates. For example, under the present law, a net estate of $50,000 will pay an estate tax of $500 in a non-community-property State and no tax in a community-property State. An estate of $100,000 will pay a tax of $9,500 on the death of the husband in a non-community-property State and a tax of $500 on the death of the husband in a community-property State.
>
> If the wife dies within 5 years of her husband, the remaining $50,000 upon which the husband paid no estate tax will be subject to an estate tax of $500. Thus, the total tax paid on this $100,000 estate in the community-property State will be $1,000 as compared with $9,500 in the non-community-property State or a tax saving of $8,500. In the case of a $5,000,000 estate, the tax saving in a community-property State will amount

* Now $60,000. [Ed.]

to as much as $485,800 and in the case of a $10,000,000 estate, the tax saving in a community-property State will amount to as much as $1,171,800.

And see S. Rep. No. 1631, 77th Cong., 2d Sess., p. 231.

Much may be said for the community property theory that the accumulations of property during marriage are as much the product of the activities of the wife as those of the titular bread-winner. But I can see no constitutional reason why Congress may not credit them all to the husband for estate tax purposes. The character and extent of property interests under local law often determine the reach of federal tax statutes. *Helvering* v. *Stuart*, 317 U.S. 154, 161–162, and cases cited. And see Cahn, "Local Law in Federal Taxation," 52 *Yale L. Journ.* 799. Yet that is not always so. *United States* v. *Pelzer*, 312 U.S. 399. Taxation is eminently a practical matter. Congress need not be circumscribed by whatever lines are drawn by local law. It may rely, as *Tyler* v. *United States*, 281 U.S. 497, 502–503, held, on more realistic considerations and base classifications for estate tax purposes on economic actualities. It was held, to be sure, in *Hoeper* v. *Tax Commission*, 284 U.S. 206, that a State could not assess against the husband an income tax computed on the combined total of his and his wife's income. But I can see no reason why that which is in fact an economic unit may not be treated as one in law. For as Mr. Justice Holmes pointed out in his dissent, there is a community of interest "when two spouses live together and when usually each would get the benefit of the income of each without inquiry into the source." And he went on to say "Taxation may consider not only command over, but actual enjoyment of, the property taxed." 284 U S. pp. 219–220. *Cf. Helvering* v. *Clifford*, 309 U.S. 331, 335–337.

The Congress has not gone the full distance here. It has not included in one estate all the property owned by husband and wife. So far as this case is concerned, it has only included in the estate of the husband the accumulations which under the community property system are deemed to have been produced by the joint efforts of him and his wife. I can see no obstacle to that course unless it be the uniformity clause of the Constitution. Art. I, §8, Cl. 1. But there can be no objection on that score. On the facts of this case the law goes no further than to eliminate the estate tax advantage which a married rancher, business man, *etc.*, in Louisiana has over those similarly situated in the common law States. Congress, to be sure, has disregarded the manner in which Louisiana divided "ownership" of property between husband and wife. But as between husband and wife, notions of "vested interests," "ownership," and the like, established by local law, are no sure guide to what "belongs" to one or the other in any practical sense. We would be blind to the usual implications of the intimate relationship of marriage if we forced Congress to treat such divisions of "ownership" the same way it does divisions of "ownership" among strangers. I find no such compulsion in the Constitution.

MR. JUSTICE BLACK joins in this opinion.

Note

1. Does the Constitution require an exclusion of property traceable to the survivor's earnings, *i.e.*, could all community property be taxed in the estate of the first spouse to die? Could the separate property of both *H* and *W* be so treated? See Eisenstein,

"Estate Taxes and the Higher Learning of the Supreme Court," 3 *Tax L. Rev.* 395, 549–561 (1948).

2. The income tax advantages enjoyed by couples in community property jurisdictions were left unimpaired by the Revenue Act of 1942, and during the next few years the community property system spread rapidly. *Supra*, p. 285. In 1948, as was seen *supra*, pp.285-9, married couples in common law property states were granted the right to split their income by filing joint returns. At the same time, the estate and gift tax laws were amended to accord to such couples a "marital deduction" and the privilege of splitting gifts, and the 1942 community property provisions were repealed. The 1948 changes in the federal income, estate and gift tax laws led to a repeal by the "new" community property states of their community property laws. *Supra*, p. 289.

REPORT OF SENATE COMMITTEE ON FINANCE, 80th CONG., 2D SESS.

S. Rept. No. 1013, pp. 26–27, reprinted in 1948–1 C.B. 285, 304–305

Unfortunately, a number of problems have arisen under the 1942 amendments. Most important of these is the fact that geographical equalization has not been realized in a typical situation. Furthermore, the problem of determining the economic contribution of the surviving spouse to the community has resulted in an extremely difficult problem of "tracing." Severe hardship also results where, because the entire community property is includible in his gross estate, the estate tax of the decedent is larger than the community property subject to his power of disposition. For example, if a decedent is economically responsible for the entire community this average tax rate on his estate may exceed 50 percent. However, only half of the community is subject to his power of disposition. Thus the share of the community already belonging to his spouse may be required to bear part of the tax although the spouse does not inherit any property under State law.

The most obvious instance of the failure to attain equalization results from the widespread use of life tenancies in the common-law States. In this situation the husband transfers or bequeaths to his wife a life estate, with remainder over to the children. At his death the whole of the estate is taxed, but at the wife's death there is no tax on the cessation of her life estate. On the other hand in a community-property State, the husband may not by his will dispose of his wife's interest in community property. If he bequeaths his one-half interest in the community to his wife for life with remainder over to the children, the entire community may be included in his gross estate, and on the death of the wife,[1] one-half the community is also included in her estate. Thus the common-law couple is subject only to a single transfer tax, whereas the community-property couple pays two transfer taxes, one on an estate of equal size and one on an estate of half the size of that passing in the common-law State.

The "tracing problem" arises under the 1942 amendments because of the need for identifying portions of the community contributed by each spouse. Establish-

[1] Assuming that the deduction for property previously taxed is not applicable. [Section 812(c) of the 1939 Code (entirely revised by the 1954 Code, *infra*, p. 1231) permitted property that had been previously taxed in the estate of another decedent to be deducted, under certain conditions, in computing the heir's gross estate, if the heir died within 5 years. Ed.]

ing the fact that particular assets of the community are derived from "compensation for personal services actually rendered by the survivor . . ." is impossible in a great many situations. Under the 1942 amendments this tracing problem is of far larger dimensions in community-property States than in common-law jurisdictions, where it is limited primarily to joint tenancies, tenancies by the entirety, and joint bank accounts.

Your committee does not believe that a satisfactory solution to the problem of geographical equalization or the difficulties of tracing can be found under the 1942 amendments or amendments using a similar theoretical approach. Hence, the repeal of these amendments is recommended, effective with respect to gifts made after the date of enactment of this bill and with respect to the estates of decedents dying after the date of such enactment.* Your committee would be unwilling, however, merely to repeal the 1942 amendments. Repeal alone would reproduce the pre-1942 results which are even further from equalization than existing law.

With the repeal of the 1942 amendments your committee recommends estate and gift tax splitting which is similar in its effects to the splitting of the income tax provided for in this bill. It is recognized that complete equalization of the estate and gift taxes cannot be achieved because of the inherent differences between community property and noncommunity property. However, the new provisions will result in equality in the important situations.

Under the estate-tax provision of your committee's bill a decedent spouse is allowed a marital deduction from his gross estate in the amount of the value of all interests in property passing outright from the decedent to the surviving spouse by way of bequest, devise, transfer, right of survivorship in jointly held property, *etc.* The deduction is limited to an amount not in excess of 50 percent of the adjusted gross estate.[2]

VETO MESSAGE FROM PRESIDENT TRUMAN

H. Doc. No. 589, 80th Cong., 2d Sess., p. 4

In the case of the estate and gift taxes, nearly all of the $250,000,000 annual reduction would go to only about 12,000 of the most wealthy families. The discovery that it is possible to make very substantial savings in the gift and estate taxes by dividing a family's wealth between husband and wife has brought forth much ingenious argument to the effect that the provisions in this bill are needed to equalize the application of these taxes in community-property and common-law States. In fact, this equalization was in all essential respects achieved by legislation enacted by the Congress in 1942.

Note

1. The bill was passed over President Truman's veto on April 2, 1948.

2. On the "tracing problem," see *Estate of Neumann* v. *Commissioner*, 9 T.C. 1120

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* As enacted, the repeal was effective for estates whose decedents died after December 31, 1947. [Ed.]

[2] The adjusted gross estate is determined by subtracting from the gross estate the debts and charges provided in section 812(b) of the [1939] Internal Revenue Code.

(1947). If both *H* and *W* invested separate property in a business and then both performed services without drawing definite salaries, the assets on the death of one would have to be allocated, under the 1942 amendments, among four categories: (1) decedent's separate property; (2) survivor's separate property, (3) community property earned by decedent; and (4) community property earned by survivor. Categories (1) and (3) would be taxed to decedent's estate. Even after the 1948 repeal of the 1942 amendments, it is necessary to allocate such assets among three categories: (1) as above; (2) as above; and (3) community property. This, of course, is because 100 per cent of (1) but only 50 per cent of (3) is taxed to decedent's estate. Is this allocation substantially less onerous than the "tracing" required under the 1942 amendments? *Cf. Todd* v. *Commissioner,* 7 T.C. 399 (1946), aff'd., 165 F.2d 781 (9th Cir. 1948).

Gift Tax

Note

1. What is the gift tax liability on a gratuitous transfer of community property to a third person? As to the husband's power to make a gift of community property without his wife's consent, see de Funiak, *Principles of Community Property,* Section 122 (1943); Coulter, "Limitations on the Power of a Community Manager to Make Gifts of Community Property," 28 *Ore. L. Rev.* 210 (1949).

Is there a gift tax on the conversion of community property into the separate property of *H* or *W?* On the conversion of separate property into community property? Is the $3,000 exclusion applicable in the latter instance? *Roeser* v. *Commissioner,* 2 T.C. 298, 303 (1943); *Perkins* v. *Commissioner,* 1 T.C. 982 (1943); *Damner* v. *Commissioner,* 3 T.C. 638 (1944).

2. In 1942, the gift tax, like the estate tax, gained new control over the community property states; a new subsection, §1000(d) of the 1939 Code, provided:

> (d) Community Property.—All gifts of property held as community property under the law of any State, Territory, or possession of the United States, or any foreign country shall be considered to be the gifts of the husband except that gifts of such property as may be shown to have been received as compensation for personal services actually rendered by the wife or derived originally from such compensation or from separate property of the wife shall be considered to be gifts of the wife.

The constitutionality of the provision was upheld, on the authority of *Fernandez* v. *Wiener,* in *Francis* v. *Commissioner,* 8 T.C. 822 (1947) and, more curtly, though it was only a day after Christmas, in *Beavers* v. *Commissioner,* 165 F.2d 208 (5th Cir. 1947), cert. den. 334 U.S. 811. See Altman, "Community Property and the Gift Tax," 21 *Taxes* 429 (1943); Taylor, "Comments on the Federal Estate and Gift Tax Provisions Re Community Property," 19 *Calif. S.B.J.* 106 (1944); *Commissioner* v. *Mills,* 183 F.2d 32 (9th Cir. 1950).

3. The Revenue Act of 1948 repealed the 1942 amendment as to gifts after April 2. 1948 and went on, as in the case of the estate tax, to confer on the citizens of common law jurisdictions the privileges previously limited to community property states. Gifts to third parties may be treated as having been made one-half by each spouse, under the circumstances set out in §2513. A gift by one spouse to the other may give rise to a "marital deduction" to the extent of one-half its value in computing the donor's net gifts. Sec. 2523.

Section D. The Marital Deduction: Section 2056

SURREY

FEDERAL TAXATION OF THE FAMILY—THE REVENUE ACT OF 1948

61 Harv. L. Rev. 1097, 1117–22, 1125–36, 1140–43 (1948)
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The splitting of marital income for income tax purposes had been discussed for a number of years [before 1948]. The merits and demerits of the proposal had been carefully examined by expert and non-expert. Its consideration and final adoption by the Congress this year [1948] represented the culmination of an orderly process of tax revision. But the splitting of estates and gifts simply rode in unheralded and uninspected on the coattails of splitting of income. "Geographical equalization" became the open sesame and the doors of the estate and gift taxes parted. Before they closed again one-third of the revenue from these taxes had been lost, and to their provisions had been added a lengthy set of complex, hastily constructed, and incompletely analyzed sections that overnight changed their entire operation. The impact upon estate planning, upon the disposition of property within the family, is immediate and startling. Yet on passage of the Act, only a relative handful of attorneys close to the theater of operations even approached awareness of what these provisions involve, and it will be many months or even years before operative understanding of all of their ramifications is achieved by tax practitioners. Individuals will die, and their families will experience an unnecessarily large tax because lawyers have not had adequate opportunity to read, understand, and act.

The 1942 Amendments.—We may at this point postpone further criticism of the estate and gift tax changes in favor of a description of what actually took place. But first, a page of history. The 1941–42 drive to end the community property income discrimination had ended in 1942 in the sacrifice by the community property states of their estate and gift tax advantages as the price of keeping their income tax benefits. Briefly, under the amendments in the Revenue Act of 1942, on the husband's death he would no longer be taxed on only one-half of the community property held by him and his wife. Instead, his estate would include all community property except that received as compensation for services rendered by his surviving spouse or derived from such compensation or separate property of that spouse. Hence, in place of the legal ownership of community property there was substituted as the touchstone of taxability economic attribution to the husband as the source of the property. General equality was thereby achieved with the common law husband who was taxed in full because of legal ownership, and who was the economic source of the property as well. But where the wife died first, since under the community system she possessed testamentary right to dispose of one-half of the community property, one-half of the property so held at her death was included in her taxable estate. Thus, in this instance legal rights derived from state property law supplied the criterion to taxability.

In the case of the gift tax, the rule that a gift of community property was

taxable one-half to each spouse was similarly supplanted by taxation to the husband except where he was not the economic source of the community property. As a corollary, transformation of separate property into community property no longer constituted a gift of one-half of the property to the wife, whereas the conversion of community property into the separate property of each, previously untaxed, was made a taxable gift of one-half by the husband.

Community property lawyers never reconciled themselves to this cross fire of economic attribution and legal ownership, although the Supreme Court in *Fernandez* v. *Wiener* stamped the stratagem constitutional. In addition to this ideological grievance, community property lawyers pleaded (1) discrimination in substance and (2) difficulty in practical operation. As to the first, they pointed out that a common law husband could leave his property with a life estate to his wife, remainder to the children, the entire bequest outright or in trust, and pay but one tax on his death with no tax on the life-tenant wife at her death. Since one-half of the community property must go in full ownership to the wife, the community property family could not accomplish this, but could only utilize the combination of life estate and remainder as to one-half of the property, thereby paying one full tax on the husband's death and another tax on one-half of the property at the wife's death. These lawyers did not accept the answer that they retained advantages in other instances. Thus, if the community property wife died first and left her share to the children (which she generally did not do, especially where a business was involved), and the husband on his death in turn left his share to the children, the family paid thereby only two taxes on one-half of the estate — a lesser tax than the one tax on the whole estate in the common law situation.

As to difficulty in practical operation, the second objection, they pointed to the many problems involved in tracing property to its economic source, and described some extreme situations in which the source being neutral, as where property had been developed on credit, the property might be taxed to the first to die. Although admittedly some such difficulties did exist, in most cases tracing did not cause trouble. Almost always, the property was clearly traceable to the husband. Moreover, as a result of the rule that when the wife died first one-half of the community property was included in her estate regardless of source, only if more than one-half could be traced to her did accurate tracing become a problem upon her prior death. But again this was not considered an acceptable answer by the community property lawyers.

It will serve no useful purpose to explore the interregnum of the 1942 amendments, for they are no longer with us and are not likely to return to the scene. The new [1948] Act discards them completely. The repeal for estate tax purposes is effective as to decedents dying after December 31, 1947, while the repeal for gift tax purposes is effective as to gifts after April 2, 1948, the date of the enactment of the new Act. The 1942 amendments will thus linger on for a while only in litigation and to determine future computations under the cumulative gift tax and the gift tax credit if gifts were made while these amendments were in effect. In their place are automatically restored (without any explicit statutory direction to that effect being necessary) the pre-1942 community property rules as evolved through court decision and administrative ruling, so that remembrance of things past becomes important. The repeal and pre-1942 restoration, however,

merely revived the problem of inequality. But now, instead of taking the 1942 road seeking equation of the tax on community property to the level existing in the common law states, the Congress proceeded to take the other fork, and attempted equation of the common law tax burden to the level existing in the community property states under the pre-1942 rules. This of course parallels its action in the income tax field in adopting the split-income or community property income tax division. But while superficially the parallel may appear exact, on analysis it would seem clear that the estate and gift tax dog does not really have an income tax tail. Nevertheless, the decisions at nearly every stage in the new estate and gift tax structure are based upon this attempt to produce tax results under common law property rules that are equal to the restored tax situation under community property rules.

A. The Estate Tax

Allowance of Marital Deduction in General. — The *deus ex machina* to accomplish this equality is the new marital deduction effective as to decedents dying after December 31, 1947. In general, there is allowed as a deduction from the gross estate an amount equal to the value of property passing from the decedent to his surviving spouse, but such deduction cannot exceed one-half of the estate. A common law husband who leaves one-half of his property at his death is thus taxed on only one-half of his property — the result in a simple community property situation. The 50% limitation is phrased in terms of one-half of the value of the "adjusted gross estate," a new estate tax concept which exhausts its function with the computation of the limitation.*

This marital deduction could not fully apply to community property, for then a community property husband would be taxed on only one-half share of that property which is included in the gross estate. Hence, in determining the adjusted gross estate, the gross estate is also reduced by the value of any community property included in it.† The 50% ceiling on the marital deduction is then computed. . . .

The Marital Deduction in Detail.—With these special community property rules to one side, we may now explore the marital deduction more fully. Section 812(e)(1)(A) [§2056(a), 1954 Code] provides for the deduction of: "An amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate."

Two new technical estate tax concepts — those of "passing" and of "spouse" — and one new problem — that of determining the value of the interest so passing — are involved in these few words. The first is defined in Section 812(e)(3) [§2056(e), 1954 Code], which contains an exclusive definition in terms of enumerated methods of property transference, such as bequest, inheritance, transfer, survivorship in joint tenancy, and so on. The Senate Report states that the definition is "broad enough to cover all the interests included in determining the

* The "adjusted gross estate," as defined by §2056(c)(2), is the gross estate less the deductions allowed by § 2053 (funeral and administration expenses, claims against the estate, and certain debts) and §2054 (casualty losses). [Ed.]

† By virtue of §2056(c)(2)(C), community property that was converted into separate property after December 31, 1941 continues to be treated as community property. [Ed.]

value of the decedent's gross estate under the various subsections of section 811 of the [1939] code."...

As for the second concept, "spouse," the Senate Report fixes the date of decedent's death as the datum point and a marriage not yet terminated by divorce as the criterion. For valuation of the interest passing to the spouse, the reference point is again the date of decedent's death, but the optional valuation date under Section 811(j) [§2032, 1954 Code] is available if elected for the entire estate. Section 812(e)(1)(E) [§2056(b)(4), 1954 Code] requires that the interest passing to the wife be considered reduced by any estate or inheritance tax to be paid by the spouse or out of such interest, — a provision somewhat similar to that in Section 812(d) [§2055(c), 1954 Code]* relating to charitable bequests and involving complex mathematical headaches — and also by any encumbrance upon the interest or property or any obligation imposed by the decedent and incurred by the spouse with respect to the passing of such interest.

All of these issues are new to the estate tax. Since the amount of property transferred to any particular person has hitherto not been a relevant consideration, the estate tax has successfully avoided up to now problems inherent in inheritance or accessions taxation. The charitable bequest section is an exception to this statement, but the infrequency of its application and its different approach have limited both its problems in the past and the assistance it will give as a guide under the new Act. Some may well urge that the federal tax loses its utility when it combines both types of death duties, and may rely on the 1948 changes to support the advocacy of a complete shift to accessions tax principles.

Terminable Interest Rule. — So far, we have considered in general terms the allowance of the marital deduction and the quantitative measurement of the interests passing to the spouse when the deduction is allowed. The most difficult question under this deduction, however, remains for discussion. In the community property model, the surviving spouse obtains a complete interest in her one-half share of the property. No other person has an interest in the property, the rights of the spouse are not terminable by any condition or her death, and the property is fully subject to gift or estate taxes in her hands. Consequently, achievement of equality in the common law states required that the marital deduction be accorded only to interests passing to the common law surviving spouse which are on a qualitative par with the interest obtained by her community property sister. It is this effort to obtain qualitative equality that causes most of the complexities under the marital deduction.

To determine which interests passing to the surviving spouse qualify qualitatively for the marital deduction, the Act [§2056(b), 1954 Code] introduces the so-called terminable interest rule. This rule, in its principal aspect, prevents an interest from qualifying if three factors are all present: (1) the interest passing to the spouse is one which will terminate or fail by reason of lapse of time or the occurrence or nonoccurrence of an event or contingency; (2) as respects the same property in which such an interest has passed to the spouse, an interest has in addition passed from the decedent, for less than an adequate consideration, to any

* *Infra*, p. 1216. [Ed.]

person other than the spouse or the spouse's estate; (3) by reason of the interest so passing to another, such other person, or his heirs or assigns, may possess or enjoy any part of the property after the termination or failure of the spouse's interest.

This rule, which, speaking generally, limits qualification to a fee simple interest, and its policy, are readily illustrated by the obvious case of property devised by the decedent to his wife for life, remainder to his children: (1) the interest — the life estate — passing to the wife will terminate on her death; (2) an interest — the remainder — in the same property has passed to others — the children; (3) by reason of such remainder interest, the children (or their heirs or assigns) may possess or enjoy the property when the wife dies. Therefore, the life estate interest does not qualify, and for policy reasons should not have been expected to qualify, since it in no way resembles the complete interest of the community property spouse. . . .

As to the first of the three factors producing disqualification, the interest may terminate because of a condition — "to my wife as long as she remains unmarried"; because of lapse of time where the interest is temporally limited — a term for years or a life estate; or because of lapse of time where the life of the property itself is limited — a patent, copyright, or annuity. But the fact that the interest in the property may cease through an act of the spouse — as by sale or gift of the interest, or through consumption of the property in the case of a bequest of $10,000 — does not make the interest terminable.

The decision that the interest is terminable doesn't *per se* disqualify, since the remaining two factors must also be present. Hence, insurance on the decedent's life payable entirely to the surviving spouse in installments for her life, or the bequest of a patent or copyright to the spouse, are deductible under the marital deduction, since no other person has an interest in the property. Conversely, the existence of such an interest in another in the property doesn't *per se* disqualify if the spouse's interest is not terminable, *e.g.*, a devise to X for life, remainder to the spouse, or a devise to spouse and daughter as tenants in common. But if the latter devise is a joint tenancy, so that the spouse's interest is terminable if she dies and the daughter has an interest by reason of which she may possess the entire property if she survives, all three factors producing disqualification are present. Change the devise once more to one to spouse and daughter as tenants in common for the spouse's life, remainder to spouse's estate. The spouse now has a terminable interest, the daughter has an interest, but the daughter's interest is not such as to permit her to possess after the spouse's death, and the deduction is allowable because of the consequent absence of the third factor. It may be noted that the concept of "passing from the decedent," discussed above in considering the acquisition of an interest by the spouse, is utilized again in connection with the acquisition of interests by other persons.

Having forcibly stressed the need for all three factors if disqualification of the interest passing to the wife is to occur, we must now, in the spirit of most tax rules, refer to an exception where the second and third factors may be absent. If the decedent directs the executor or the trustee of a trust to acquire a terminable interest for his surviving spouse, the interest so acquired does not qualify. [§2056(b)(1)(C), 1954 Code.] Thus, if the decedent directs the executor to

purchase a $100,000 annuity for his wife, no deduction is allowable. If he bequeaths $100,000 to her and she purchases the annuity, all is well. Here the choice on how to consume the $100,000 is the wife's and not the decedent's, so that a policy distinction exists. But suppose the decedent during his life takes out an annuity for the joint lives of his wife and himself and the life of the survivor — here a deduction is allowable although the wife receives exactly the same interest on death as in the case of the executor's purchase. Perhaps the policy difference lies in the commitment during life by the decedent, whereas in the executor situation the decedent has free use of the assets until death. But suppose a tax-wise decedent instructed a bank to purchase an annuity on direction of his attorney, so that under such a previous arrangement the purchase could be consummated in a few minutes when decedent is approaching death. The answer is probably that to permit this arrangement would be a policy distortion, just as permitting a purchase by the executor to qualify would have afforded too easy an avoidance of the terminable interest rule.

The Act contains another and more severe safeguard of the primary policy evidenced in the terminable interest rule. If a bequest to the wife of, say $20,000, is in outright terms, but may be satisfied in whole or part out of assets with respect to which no deduction would be allowable if they had passed to the wife, then the amount of the bequest is reduced by the amount of such assets and only the balance if any is deductible Hence, if the assets of the estate out of which the $20,000 bequest could be satisfied included the use of a house which the decedent had previously given to his children reserving therein a term of years, and the balance of the term is worth $20,000 at death, no deduction is available although the estate also includes $100,000 in bonds. The policy here is not so clear. The wife is entitled to obtain $20,000 in cash and there are assets available to provide that sum without resort to the terminable interest. Perhaps the rigorous rule adopted is deemed necessary to prevent terminable interests from passing through the device of a verbally outright bequest behind which is an understanding that the wife will accept a terminable interest in payment thereof. Policy aside, it should be kept in mind that many a bequest thought deductible will be lost if sudden death finds the husband with assets of such a disqualifying nature.

Exceptions to the Terminable Interest Rules. — The Act permits three exceptions to the terminable interest rule in order to afford some flexibility of disposition in transfers to the surviving spouse. The first exception [§2056(b)(3), 1954 Code] accommodates common disaster and early death clauses contained in many wills. A transfer of an interest to the spouse which can fail because of such clauses — for example, if she dies as a result of a common disaster, or if, regardless of common disaster, she dies within thirty days of the decedent, the bequest shall not take effect — does not render the interest terminable for the purpose of the disqualifying rule if the spouse in fact survives. But six months is the limit allowed for these defeating contingencies, so that a clause defeating the bequest if the spouse dies before final distribution of the estate, would also defeat the deduction, since such distribution may require more than six months Similarly, a clause in an insurance policy that the proceeds shall not go to the spouse-beneficiary if she dies before proof of death of the insured is submitted to the insurance company may not comply with the six-months' exception.

The second exception [§2056(b)(5), 1954 Code] permits the decedent to leave

property in trust * for the wife's benefit during her life, with a power of appointment in the wife to appoint at least to herself or her estate. In such a situation the interests of the spouse approach complete ownership of the property and the trust corpus will be taxable to her at her death.† This exception, however, in keeping with its justification, is hedged with a number of restrictions that considerably reduce its flexibility. (1) The spouse must be entitled to the entire trust income as long as the trust is in existence, and such income must be paid annually or at more frequent intervals. A power of mandatory or discretionary accumulation in the trustee will prevent qualification. (2) The spouse must have the power to appoint the entire corpus free of the trust, and the power must be exercisable in her favor or that of her estate. . . .

The third exception [§2056(b)(6), 1954 Code] applies a similar policy under similar restrictions to proceeds under a life insurance, endowment, or annuity contract. The proceeds may be payable either in installments or held by the insurer at interest, but all such installments or interest payable during the wife's life must be payable only to her, and payable annually or at more frequent intervals. The wife must have the requisite power to appoint all ‡ amounts payable under the contract. . . .

These last two exceptions permit the decedent to obtain a marital deduction and still in some degree guard against unwise management of the property by the surviving spouse, but do not enable him to assure ultimate enjoyment by desired beneficiaries, such as children. For the latter, he must rely upon his spouse's future conduct. . . .

B. The Gift Tax

Gift to Spouse.—Equalization under the gift tax follows a pattern similar to that of the estate tax changes. The 1942 community property amendment is repealed as to gifts made after April 2, 1948. Henceforth, if community property is made the separate property of husband and wife, no gift tax results on the conversion, but if separate property is transformed into community property there is a gift tax. A community property husband can once more, in effect, transfer half of his earnings to his spouse free of the gift tax. For common law husbands a marital deduction has been introduced in case of a gift to a spouse, the deduction being one-half the amount of the gift. [§2523, 1954 Code.] The estate tax marital deduction is the amount of the interest passing to the spouse and is limited to one-half the adjusted gross estate; the gift tax marital deduction is one-half the amount of the gift.

These two deductions combine to produce a rough equalization where there

* Under the 1954 Code, the property need not be left in trust, as was the requirement before 1954. A legal life estate with a power of appointment will now qualify. Moreover, if the surviving spouse is entitled to the income from, and can appoint, a specific portion of the property, that portion will qualify. Before 1954, the wife's income interest and power of appointment had to extend to the entire corpus. [Ed.]

† As mentioned *supra*, p 976, if a general power of appointment is created after 1942, the property subject to the power must be included in the estate of the donee (*i.e.*, the person possessing the power) whether he exercises it or not. [Ed.]

‡ The 1954 Code modified this provision also, so that if only a specific portion of the amounts payable can be appointed by the surviving spouse, that portion will qualify. [Ed.]

is an *inter vivos gift.* If a common law husband earns $100,000 and gives $50,000 to his wife, there is a gift tax on $25,000 (disregarding the exemption and exclusion); no gift occurs, however, in a community property state. When the common law husband dies and leaves the remaining $50,000 to his wife, estate tax is paid on $25,000; whereas estate tax is paid on $50,000 if the community property husband leaves his $50,000 share to his wife. Here the common law family may be ahead taxwise as a result of the gift tax exemption and lower gift tax rates (despite earlier deprivation of the use of the gift tax money). But if each husband leaves the $50,000 at death to his children, each pays an estate tax on $50,000, and the community property couple is here ahead. In short, a half-of-the-gift marital deduction in the common law state is not the same as a half-of-the-property ownership in the wife by operation of law in the community property state.

There is a community property exception to the marital deduction, similar in principle to that under the estate tax, to prevent the donor from obtaining its benefit when he gives his share to his spouse. Section 1004(a)(3)(F)(i) [§2523(f), 1954 Code] allows the marital deduction only if it can be shown that the property transferred by gift to the spouse is not held as community property at the time. . . .

Here also we have the terminable interest rule to govern qualification for the marital deduction. [§2523(b), 1954 Code.] The Senate Report states that the rule generally corresponds to that under the estate tax and that the provisions of each tax are to be construed in the same manner. Since the donor is here alive, retention by him of an interest in the property in which he has given his spouse an interest is an additional situation satisfying the "interest in another person" factor; for example, life estate to the wife, reversion in donor is not entitled to a marital deduction with respect to the life estate. To insure disqualification where the donor retains a power of appointment (since such a power is not regarded as an interest in property), there is an express provision covering such a case. But where the property is transferred by the donor spouse in a joint tenancy or a tenancy by the entirety, the survivorship and severance interests are specifically eliminated as disqualifying interests, so that only one-fourth of the property is taxable on the creation of such a tenancy by the donor. Finally, there is the exception to the terminable interest rule for the trust* in which the spouse receives the income and the requisite power of appointment.

Gift of Husband or Wife to Third Party. — As a result of the repeal of the 1942 amendments, the gift of community property to a third party is again considered to constitute a gift of one-half of the property by each spouse. Equalization demanded like treatment in a common law state. Here, the method is almost exact imitation of the community property model. Section 1000(f) [§2513, 1954 Code] provides that, if husband and wife consent, a gift after April 2, 1948, to a third party shall be considered, for the purpose of the gift tax chapter, as a gift one-half by the husband and one-half by the wife. The manner of signifying consent is made subject to regulations, but with certain standards specified in the

* As indicated *supra*, p. 1023, a legal life estate now qualifies if coupled with a power of appointment. [Ed.]

Act governing the time within which consent must be given or revoked. If given, the consent applies to all gifts during the year, and for all future computations involving such gifts. Presumably it does not apply to gifts made in the succeeding years, as to these a new consent is necessary each year.

Note

The "marital deduction" created by the Revenue Act of 1948 will be encountered again *infra*, pp. 1216–1225.

Chapter 12

THE GROSS ESTATE: TRANSFERS DURING LIFE

Section A. Jointly-held Property: Section 2040

Internal Revenue Code of 1954

Sec. 2040. Joint Interests.

The value of the gross estate shall include the value of all property (except real property situated outside of the United States) to the extent of the interest therein held as joint tenants by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth Provided, That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than an adequate and full consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person. . . .

PAUL
FEDERAL ESTATE AND GIFT TAXATION

Boston: Little, Brown and Company, 1942, Sections 8.03, 8.07
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A tenancy by the entirety is limited to the relationship of husband and wife and originated because of the common law principle of marital unity. Each spouse is said to own the entire property with no division of interests into separate portions. Neither spouse may alienate the whole or any portion of the property during their joint lives without the consent of the other. And neither may devise it to another at death, as the important characteristic of the tenancy is the absolute right of the surviving spouse to continue to hold the entire, sole interest in the whole property, unfettered by a like interest held by the deceased spouse before death.

The common law favorite among estates held by more than one person was the "joint tenancy." Many of its virtues are outmoded today, and state statutes have changed or abolished its former characteristics. Originally four unities were necessary to create this tenancy. Each tenant must have had one and the same interest, commencing at the same time, received by the same conveyance and held by undivided possession. As in the case of tenancies by the entirety, a

surviving joint tenant under common law acquired the interest of the deceased tenant and neither had any power of testamentary disposition. But unlike tenancies by the entirety, a joint tenant might dispose of his interest during his lifetime without the consent of his joint tenant. . . .

The provision of the statute under discussion has no reference to property held by the decedent and any other person or persons *as tenants in common.* This makes it important to distinguish between property held jointly or as tenants by the entirety, and property held as tenants in common. The question whether a joint tenancy has been created may be a question of fact or law. The answer to the question may to some extent reside in local law. It has been held that the question whether ownership of stock of foreign corporations is joint or in common is to be decided by the laws of the place where an assignment of the stock was made and the parties resided.

So far as the taxing statutes are concerned, the most important characteristic in any of the tenancies mentioned is what are termed survivorship rights. Under the common law tenants in common were said to hold separate and divided interests in the property. Each tenant could sell or transfer at will, and at the death of one the survivor received no rights in the deceased's share merely by virtue of the tenancy. Each tenant's share descended to his heirs or could pass by testamentary disposition. Tenants in common, since they hold separate interests, may own unequal shares in the property, though in the absence of evidence to the contrary, they are presumed to hold equal shares. Today this is the general rule, and a true tenancy in common is not a productive vehicle of estate tax avoidance as tenancies by the entirety and joint tenancies would have been but for the enactment of a provision covering the situation.

UNITED STATES v. JACOBS

Supreme Court of the United States, 1939
306 U.S. 363

MR. JUSTICE BLACK delivered the opinion of the Court.

The question is whether the entire value or only one-half the value of real property—purchased by a decedent with his own funds and held at his death by his wife and himself under a joint tenancy set up prior to 1916—may be included in the decedent's gross estate under the 1924 Revenue Act.*

In 1909, real estate in Illinois was conveyed to W. Francis Jacobs, the decedent, and Elizabeth C. Jacobs, his wife, "as joint tenants" and this joint tenancy continued until decedent's death; the wife never contributed any part of, or consideration for, the joint property; decedent died June 17, 1924 (after the effective date of the 1924 Revenue Act), and as survivor the wife became sole owner in fee of the whole of the joint property.

The Commissioner included the full value of the property in decedent's gross estate for taxation under the 1924 Act. . . .

* The 1924 provision was identical with §2040 of the 1954 Code, except that it used the term "fair consideration" instead of "adequate and full consideration." [Ed.]

. . . Contending that the tax as so applied is retroactive, respondent insists that the Due Process Clause of the Fifth Amendment forbids such taxation. The reasoning is that a one-half interest in the joint property was transferred to, and vested in, the wife in 1909, that the tax in question only applies to transfers; and that the one-half interest transferred to the wife in 1909 could not thereafter (1924) be taxed as a part of decedent's gross estate without retroactively applying the tax to the 1909 transfer.

But the tax was not levied on the 1909 transfer and was not retroactive. At decedent's death in 1924, ownership and beneficial rights in the property which had existed in both tenants jointly changed into the single ownership of the survivor. This change in ownership, attributable to the special character of joint tenancies, was made the occasion for an excise, to be measured by the value of the property in which the change of ownership occurred. Had the tenancy not been created, this survivorship and change of ownership would not have taken place, but the tax does not operate retroactively merely because some of the facts or conditions upon which its application depends came into being prior to the enactment of the tax.

Death duties or excises imposed upon the occasion of change in legal relationships to property brought about by death are ancient in origin. Congress has the power to levy a tax upon the occasion of a joint tenant's acquiring the status of survivor at the death of a co-tenant. In holding that the full value of an estate by the entirety may constitutionally be included in a decedent's gross estate for estate tax purposes, the Court said:

> The question . . . is, not whether there has been, in the strict sense of that word, a "transfer" of the property by the death of the decedent, or a receipt of it by right of succession, but whether the death has brought into being or ripened for the survivor, property rights of such character as to make appropriate the imposition of a tax upon that result (which Congress may call a transfer tax, a death duty or anything else it sees fit), to be measured, in whole or in part, by the value of such rights. . . .
>
> At . . . [the co-tenant's] death, however, and because of it, . . . [the survivor] for the first time, became entitled to exclusive possession, use and enjoyment; she ceased to hold the property subject to qualifications imposed by the law relating to tenancy by the entirety, and became entitled to hold and enjoy it absolutely as her own; and then, and then only, she acquired the power, not theretofore possessed, of disposing of the property by an exercise of her sole will. Thus the death of one of the parties to the tenancy became the "generating source" of important and definite accessions to the property rights of the other. These circumstances, together with the fact, the existence of which the statute requires, that no part of the property originally had belonged to the wife, are sufficient, in our opinion, to make valid the inclusion of the property in the gross estate which forms the primary base for the measurement of the tax.[1]

Thereafter, it was further decided that the full value of the property passing to a survivor under a tenancy by the entirety created prior to the estate tax of 1916 could be included in the gross estate.[2] Congress—it has been held—may also constitutionally apply an estate tax to the whole of a joint tenancy created

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[1] Tyler v. United States, 281 U.S. 497, 503, 504.

[2] Third National Bank & Trust Co. v. White, 45 F.2d 911, affirmed 287 U.S. 577; Helvering v. Bowers, 303 U.S. 618.

after the 1916 Act,[3] and to half of a joint tenancy created prior to the 1916 Act, where the decedent alone had furnished consideration for the joint property.[4]

It is urged that these decisions do not support the tax here upon the full value of the joint property, because this tenancy was created prior to the estate tax law of 1916. Respondent relies upon differences in the nature of tenancies by the entirety and joint tenancies in order to remove the present case from the application of these prior adjudications. Since a joint tenant's interest in realty is severable and subject to sale, the argument is that upon the death of a co-tenant the survivor actually receives nothing more than the decedent's one-half interest and therefore no more can be subjected to a death duty. On the other hand, respondent explains the permissible taxation of the whole of a tenancy by the entirety by reference to the "amiable fiction" of the common law, under which ownership of a husband and wife in tenancy by the entirety is deemed a single individual unity and each owns all and every part of the property so held. By virtue of this feudal fiction of complete ownership in each of two persons, the surviving tenant by the entirety is conceived to be the recipient of all the property upon the death of the co-tenant, and therefore—it is said—all the property can be taxed.

The constitutionality of an exercise of the taxing power of Congress is not to be determined by such shadowy and intricate distinctions of common law property concepts and ancient fictions. The Constitution grants Congress the "Power to lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defence and general Welfare." No more essential or important power has been conferred upon the Congress and the presumption that an Act of Congress is valid applies with added force and weight to a levy of public revenue.

In addition, there is sufficient substantial similarity between joint tenancies and tenancies by the entirety to have moved Congress to treat them alike for purposes of taxation. Practical necessities—and taxation is "eminently practical" [5]—may well have led Congress to group different types of joint ownership together for taxation rather than to afford different treatment to each varying shade of such ownership. A tenancy by the entirety "is essentially a joint tenancy, modified by the common law theory that husband and wife are one person." [6] Only a fiction stands between the two. Survivorship is the predominant and distinguishing feature of each. The "grand incident of joint estate is the doctrine of survivorship, 'by which, when two or more persons are seized of a joint estate, . . . the entire tenancy upon the decease of any of them remains to the survivors, and at length to the last survivor; and he shall be entitled to the whole estate, whatever it may be.' " [7]

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[3] Foster v. Commissioner, 303 U.S. 618.

[4] Gwinn v. Comm., 87 U.S. 224; Griswold v. Helvering, 290 U.S. 56, 58. In the Griswold case this Court said: "Whether this application of the statute gives it a retroactive effect is the sole question here involved, and with that we find no difficulty. Under the statute the death of decedent is the event in respect of which the tax is laid. It is the existence of the joint tenancy at that time, and not its creation at an earlier date, which furnishes the basis for the tax."

[5] Nicol v. Ames, 173 U.S. 509, 516.

[6] 1 Tiffany, *Real Property* (1920), § 194; see, Littleton's *Tenures*, § 291 (Wambaugh, Ed., 1903).

[7] Freeman, *Cotenancy and Partition*, 2d Ed., § 12.

While it is true that until the death of decedent here each joint tenant possessed the right to sever the joint tenancy, each was nevertheless subjected to the hazard of losing the complete estate to the other as survivor. Prior to decedent's death, his wife had no right to dispose of her interest by will, nor could it pass to her legal heirs. She might survive and thereby obtain a complete fee to the property with attendant rights of possession and disposition by will or otherwise. Until the death of her co-tenant, the wife could have severed the joint tenancy and thus have escaped the application of the estate tax of which she complains. Upon the death of her co-tenant she for the first time became possessed of the sole right to sell the entire property without risk of loss which might have resulted from partition or separate sale of her interest while decedent lived. There was—at his death—a distinct shifting of economic interest, a decided change for the survivor's benefit. This termination of a joint tenancy marked by a change in the nature of ownership of property was designated by Congress as an appropriate occasion for the imposition of a tax. Neither the amount of the tax nor its application to the survivor's change of status and ownership, was in any manner dependent upon the date of the joint tenancy's creation, whether before, or after 1916. It is immaterial that Congress chose to measure the amount of the tax by a percentage of the total value of the property, rather than by a part, or by a set sum for each such change. The wisdom both of the tax and of its measurement was for Congress to determine.

The judgment . . . is reversed . . . .

MR. JUSTICE STONE took no part in the consideration or decision of these cases.

MR. JUSTICE MCREYNOLDS, MR. JUSTICE BUTLER, and MR. JUSTICE ROBERTS think that the judgment . . . should be affirmed . . . .

It has long been the settled doctrine of this court that Congress cannot retroactively tax, as testamentary, a transfer consummated in accordance with existing law before the adoption of a system of estate taxation, and where the parties, at the time of the transaction, had no notice of intent to tax it as a transfer in contemplation of death or to take effect in possession or enjoyment at or after death. In order to avoid holding taxing acts unconstitutional on this ground, the court has often construed them as applying prospectively only. Reliance is placed by the Government on decisions sustaining inclusion in the estate of one spouse of the entire value of an estate by the entireties. In the earlier cases wherein the exaction was upheld the act operated prospectively and affected only such an estate arising after passage of the statute, or the estate came into being after the adoption of a system of taxation which might well include such a transfer within its scope. Subsequently the inclusion of the entire value in the taxable estate of one spouse was sustained where the tenancy by the entireties antedated the passage of the estate tax acts.[1] The decision was based upon the peculiar nature of a tenancy by the entireties as expounded in *Tyler* v. *United States*. A transfer tax measured by one-half the value of an estate in joint tenancy has been approved although the estate was created prior to the adoption of the system of estate taxes, but the

[1] Third National Bank & Trust Co. v White, 287 U S. 577; Helvering v. Bowers, 303 U.S. 618.

court has never passed upon the validity of such a tax measured by the value of the entire joint estate. There are marked differences between a tenancy by the entireties and a joint tenancy in respect of the power of one tenant to destroy the joint estate, to transfer or encumber his interest and otherwise obtain the fruits of it. In order to prevent evasion Congress may include the value of the entire estate in the gross estate as a measure of the tax where the estate originates after adoption of the law. But it may not retroactively apply such measure to an estate created at a time when its creators had no reason to expect that such a tax would be laid in view of the settled rules of property.

Note

What are the economic differences between a tenancy by the entirety and a joint tenancy? Are they "shadowy and intricate"? Do they warrant divergent tax treatment? Why are tenancies in common taxed differently? On the constitutional issues, see Eisenstein, "Estate Taxes and the Higher Learning of the Supreme Court," 3 *Tax L. Rev.* 395, 408–421 (1948).

HARVEY v. UNITED STATES

U.S. Court of Appeals, Seventh Circuit, 1950
185 F.2d 463

Before MAJOR, Chief Judge and DUFFY and LINDLEY, Circuit Judges.

LINDLEY, Circuit Judge.

Plaintiff, as executrix of the estate of her deceased husband, Arlington C. Harvey, filed an estate tax return showing no tax due. The Commissioner assessed a deficiency in the amount of $32,151.30, which, with interest, she paid under protest. Her claim for refund having been rejected, she instituted suit in the District Court for recovery of the tax paid and obtained judgment. The principal contention of the government on appeal is that the trial court erred in deciding that certain property held by plaintiff and her husband in joint tenancy came within the scope of the exception contained in Section 811(e) of the [1939] Internal Revenue Code [§2040, 1954 Code], and, consequently, was not part of the decedent's taxable estate.

Section 811(e) provides that the gross estate of a decedent shall include the value at the time of his death of all property held as joint tenants by the decedent and any other person,

> except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth: Provided, That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than an adequate and full consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person.

The tax return disclosed that the decedent was, at the time of his death, joint owner with his wife of property of the value of $200,709.78. Plaintiff asserted the right to deduct $143,450 from the gross value, because of contributions made

by the wife, out of "funds and property separately owned" by her, in acquisition of the jointly held property. However, the Commissioner determined that the entire value of the jointly owned property, $201,859.78, should be included in the decedent's gross estate, on the basis of his finding that all of the property was held in joint tenancy and that no part thereof had been shown to have belonged originally to the wife and never to have been received or acquired by her from the decedent for less than an adequate consideration in money or money's worth.

The stipulation of facts and the District Court's findings disclose, that the decedent had, from time to time, made gifts of money and property to his wife, which, through successive investments, sales and reinvestments with resulting gains, had been transmuted into other property. The wife was at no time gainfully employed and had no property at the time of her marriage. In other words, the only assets acquired or owned by her were those given her by her husband, plus the profits and income produced by them, in either their original or converted forms, and the wife's contributions toward acquisition of the property which she held in joint tenancy with her husband at the time of his death, of necessity, emanated from these sources. The jointly held property is not the gift property itself, in either its original or transmuted form, but property traceable to (1) the profits made through sales of the original gift property and successive reinvestments of the proceeds of such sales or (2) the rents, interest and dividends produced by such property in its original or converted form, while title thereto was in the wife. The question presented by this appeal, then, is whether such profits and income, realized from property originally received by the wife as a gift from her husband and traceable into property which was held by them as joint tenants at the time of the husband's death, came within the exception to the requirement of Section 811(e) that the entire value of property held in joint tenancy shall be included in the decedent's gross estate.

The District Court, disapproving the stand taken by the Commissioner, held the profits and income from the gift property to be within the exceptions set forth in Section 811(e), reasoning that profits on resale of property given to and thereafter owned by the wife, dividends on stock, rentals from real estate and interest on bonds, from all of which sources came the money and property contributed by the wife to the jointly held property, were "her own income"; that such profits and income, received by her when she held full title to the stocks, real estate, bonds and property which produced them, were not received or acquired by her from her husband within the meaning of Section 811(e), but constituted accumulated income from property "separately owned" by decedent's wife within the meaning of the Code and Section 81.23 of Treasury Regulations 105.

If the government's contention that the Commissioner correctly determined that the full value of the jointly owned property should have been included in the decedent's gross estate for estate tax purposes is to prevail, it must show (1) that, at least for the purposes of Section 811(e) of the Internal Revenue Code, profits and income which are produced by gift property subsequent to the making of the gift do not belong "originally" to the donee but are "received or acquired" by her from the donor, for the statute expressly exempts such part of the jointly

held property as "originally" belonged to the surviving joint tenant and was not "received or acquired" by her from the decedent for less than an adequate and full consideration, or, in the alternative, (2) that the words "or produced by property which had been received or acquired" be read into the statute, so that the exception clause of Section 811(e) would read: "except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired or *produced by property which was received or acquired* by the latter from the decedent for less than an adequate and full consideration in money or money's worth . . ." The cases relied on by the government fall short, we think, of establishing either of these postulates.

In *Tyler* v. *United States*, 281 U.S. 497, the Supreme Court, in sustaining Sections 201, 202 and 401, 402, of the Revenue Acts of 1916 and 1921, the forerunners of the present Section 811(e) of the Internal Revenue Code, against attacks of unconstitutionality, held only that it was not arbitrary, capricious or violative of the due process clause of the Fifth Amendment to require that there be included in the gross estate of a decedent the total value of the property held by him and another as tenants by the entirety, the specific property having come to the tenancy as a gift from the decedent. *Dimock* v. *Corwin*, 306 U.S. 363, 371–373; and *Fernandez* v. *Wiener*, 326 U.S. 340, likewise involve questions of constitutionality, the former holding that the statutory provision here involved was applicable and, when so applied, constitutional where the property held in joint tenancy had originally been received by the surviving joint tenant, *prior to the passage of the statute*, as a gift from the decedent, and the latter upholding the constitutionality of Section 811(e)(2) of the Code (relating to the taxation of community property), which has since been repealed. 62 Stat. 116. These cases, although perhaps persuasive of the proposition that a statute requiring inclusion in the gross estate of a decedent of all property held in joint tenancy by the decedent and any other person, irrespective of the source of the property so held, would not be unconstitutional, certainly do not justify us in saying that this statute as written, is to be interpreted as the government contends it should be in the instant case.

Hornor's Estate v. *Commissioner*, 3 Cir., 130 F.2d 649 and *Stuart* v. *Hassett*, D.C., 41 F.Supp. 905, also relied on by the government, are decisions which go no further than to apply the provisions of Section 811(e) to cases which fall clearly within its orbit. In the first of these cases, it was held that the entire value of property owned by the decedent and his wife as tenants by the entirety was taxable to the decedent's estate, his wife having contributed to the tenancy nothing other than property given her by the decedent, while in the *Stuart* case it was held that, where the decedent paid for property to which title was taken in his wife's name, and that property was subsequently conveyed by the wife to a straw who reconveyed to the decedent and his wife as joint tenants, the entire value of the property was taxable to the decedent's estate. And, finally, *Estate of Howard* v. *Commissioner*, 9 T.C. 1192, the only cited case which deals with the precise question presented by this appeal, held that, of the jointly owned property there involved, that portion which was shown to have been purchased out of dividends received by the wife on stock which the decedent had previously given her was within the exception set out in Section 811(e), the Tax Court thus re-

jecting the interpretation there urged by the Commissioner, which is, of course, the very interpretation now pressed by the government.

It seems clear that none of the cases cited contains any support for the novel proposition that income produced by gift property, after the gift has been completed, belongs to the donor and is property received or acquired from him by the donee; nor is there, in these cases, anything to impeach the conclusion of the trial court, or that of the Tax Court in the *Howard* case, that the income produced by property of any kind belongs to the person who owns the property at the time it produces such income and does not originate with a donor who has made a completed gift of that property prior to its production of the income. Similarly, they fail to sustain the contention that the statute should be interpreted as excepting from inclusion in the gross estate such part of the jointly held property "as may be shown to have originally belonged to such other person and never to have been received or acquired *or produced by property which was received or acquired* by the latter from the decedent for less than an adequate and full consideration in money or money's worth." As a matter of fact, the *Dimock* case, 306 U.S. 363, 373, in which the Supreme Court refused to read into the statutory exception the words "after the passage of this Act" (which would have had the effect of bringing within the exception property which had been received by the surviving joint tenant as a gift prior to the enactment of the statute), clearly advises us that we are not justified in reading into the statute a provision which the Congress did not see fit to insert.

Although it concedes that the case of *Estate of Howard* v. *Commissioner*, 9 T.C. 1192, supports the decision of the District Court insofar as it relates to dividends, rentals and interest, the government contends that the case "apparently" supports its position with respect to profits derived from the sale of property previously received by the surviving joint tenant as a gift from the decedent. This contention is founded on the court's statement that "If the proceeds from the sale of this stock had been deposited in the joint bank account, that would be another matter." Placing these words in context, however, it is obvious that all the Tax Court was saying was that if gift property is converted into another form of property, which is then placed in joint tenancy, the converted property is not within the exception provided for in Section 811(e); its statement can not logically be interpreted as meaning that "profits" or "gains," as distinguished from "proceeds" or "property received in exchange," do not fall within the scope of the exception. Moreover, no reason is suggested for holding that one form of income, *i.e.*, "profit gained through a sale or conversion of capital assets," *Eisner* v. *Macomber*, 252 U.S. 189, 207, is outside the exception, whereas other forms of income, such as dividends, rentals and interest, fall within its terms. It follows that the government's contention that the full value of the property held in joint tenancy by decedent and his wife at the time of his death should have been included in decedent's gross estate must be rejected. . . .

The trial court's conclusion that certain certificates of shares having an aggregate value of $75,000, along with some farm equipment valued at $10,250, were owned by the decedent and his wife as tenants in common, rather than as joint tenants is also attacked. Six of the certificates were payable to "A. C. Harvey or Elizabeth Harvey"; three to "either A. C. or E. C. Harvey"; and the remaining

four to "A. C. Harvey and/or E. C. Harvey." The government argues that in each instance, the quoted language satisfies the requirements of the Illinois statute which abolished the right of survivorship as between joint owners of personal property (excepting executors and trustees) and converted joint tenancies into tenancies in common in all cases except those in which there is a "will or other instrument in writing expressing an intention to create a joint tenancy in personal property with the right of survivorship." Ill. Rev. Stat. Ch. 76, Sec. 2. With respect to the farm equipment, it is the government's position that, since it was purchased with funds drawn from a joint bank account, it too was held in joint tenancy. The United States also relies on the fact that, on the tax return, the wife as executrix, listed the certificates and the farm equipment as jointly owned property, but this fact is of no avail to the government, for the form of ownership of property is not determined by the manner in which it is listed on a tax return but by reference to the state law applicable thereto. *Greenwood* v. *Commissioner*, 9 Cir., 134 F.2d 915. And, in view of the provisions of the applicable Illinois statute, it is evident that the District Court correctly held that the farm equipment, as to which there was no written instrument of any kind to satisfy the statutory requirement, was owned by the decedent and his wife as tenants in common. Thus, the only question is whether the language of the certificates can be said to express "an intention to create a joint tenancy in personal property with the right of survivorship."

That the Illinois courts do not regard the term "either . . . or" as sufficiently expressive of an intention to create a joint tenancy is clear from the decision in *Lindner & Boyden Bank* v. *Wardrop*, 370 Ill. 310, 18 N.E.2d 897, which involved a certificate of deposit which read, "William Wardrop or Bertha Nash has deposited in this bank seven hundred fifty and no/100 dollars payable to the order of either of them. . . ." The court, stating that "no question of survivorship arises since the certificate does not so provide," held this language insufficient to create a joint tenancy. The same result was reached where certificates were issued in the names of a husband and wife and made payable to either of them. *Englebrecht* v. *Englebrecht*, 323 Ill. 208, 153 N.E. 827. Illustrative of the marked reluctance of the Illinois courts to allow creation of a joint tenancy in personal property is the recent case, *In re Wilson's Estate*, 404 Ill. 207, 88 N.E.2d 662, 663, Note, 45 *Ill. L. Rev.* 285, in which the state Supreme Court held that no joint tenancy existed with respect to the contents of a safe deposit box, though the lease card for the box bore the words "as joint tenants with the right of survivorship and not as tenants in common" and the box itself contained a note written by the husband stating that the money which was in the box was held in joint tenancy by his wife and himself. Thus, it seems clear that the District Court correctly determined that, under the law of Illinois, the certificates were held by the decedent and his wife as tenants in common and not as joint tenants.

The government has suggested that, even though it is held that the decedent and his wife owned the certificates and the farm equipment as tenants in common, still it was incumbent on the wife to show the amount contributed by her in the acquisition of this property and that only such amount may properly be deducted from the decedent's gross estate; consequently, it cites as error the District Court's allowance of the deduction of one half the value of the aforementioned

property. The fallacy in this argument is that the provisions of Section 811(e) of the Code are not applicable to property held in tenancy in common. See Treasury Reg. 105, Section 81.22. Therefore, since it is the law of Illinois, that, absent evidence to the contrary, tenants in common take equal shares, *Keuper* v. *Mette's Unknown Heir*, 239 Ill. 586, 592, 88 N.E. 218, the allowance of the deduction of one-half the value of the property so held was entirely proper.

Note

1. Is the result in the *Harvey* case in harmony with the purpose of the statute? Consider these problems of applying the *Harvey* case, assuming in each case that *H* gave *W* stock worth $50,000·

(a) *W* receives a dividend of $20,000 (no substantial profits having been realized by the corporation after the gift to *W*) and uses this sum to purchase jointly-held property. Taxable?

(b) On selling the stock for $75,000, *W* deposits the entire amount in her bank account. Thereafter she uses $25,000 to buy property in joint tenancy. Taxable?

(c) When the stock is worth $75,000, *W* uses it to purchase property in their joint name. Is this to be treated differently from the sale of the stock for $75,000, followed by a purchase of the jointly-held property for cash?

2. What if jointly-held property was purchased by *W* by check on a bank account established with funds owned by *W* before her marriage but augmented after marriage by gifts from *H*? Suppose the gifts from *H* had been deposited by *W* in a separate account? What if *W* had purchased property with funds received from *H* in reimbursement of earlier payments by *W* to defray household expenses or *H*'s debts? *Estate of McGrew* v. *Commissioner*, 135 F.2d 158 (6th Cir. 1943); *Fox* v. *Rothensies*, 115 F.2d 42 (3d Cir. 1940). *W* may be associated with *H* in business and buy jointly held property with her compensation. *Cf. Berkowitz* v. *Commissioner*, 108 F.2d 319 (3d Cir. 1939) and *Estate of Fletcher* v. *Commissioner*, 44 B.T.A. 429 (1941) *with Bushman* v. *United States*, 8 F.Supp. 694 (Ct. Cl., 1934), cert. den., 295 U.S. 756 (1935) and *Estate of Awrey* v. *Commissioner*, 5 T.C. 222 (1945). *H* and *W* buy a $20,000 house as tenants by the entirety; *H* makes a down payment of $5,000 and *H* and *W* assume a $15,000 mortgage. At *H*'s death the house is worth $30,000; the mortgage is still unpaid. How much is includible in *H*'s estate? See *Bremer* v. *Luff*, 7 F Supp. 148 (N D.N.Y., 1933), noted, 48 *Harv. L. Rev.* 340 (1934) and 44 *Yale L.J.* 687 (1935).

3. Where evidence of the respective contributions of *H* and *W* to the acquisition of jointly held property is lacking, may resort be had to local law presumptions that the contributions were equal? *Robinson* v. *Commissioner*, 63 F.2d 652 (6th Cir. 1933), cert. den., 289 U.S. 758; *City Bank Farmers Trust Co.* v. *Commissioner*, 41 B.T.A. 1 (1940) (evidence unobtainable because *H* and *W* perished in common disaster). Note reliance on local presumptions in *Fox* v. *Rothensies* and *Estate of McGrew* v. *Commissioner, supra.* What is the force of a local presumption that, if no intent to the contrary is shown, a conveyance to *A* and *B* creates a tenancy in common rather than a joint tenancy? See *Dennis* v. *Commissioner*, 26 B.T.A. 1120 (1932).

4. See generally, Rudick, "Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety," 4 *Tax L. Rev.* 3 (1948). In his article, Mr. Rudick deals with the question of the surviving tenant's income tax basis for the property for computing gain or loss on a subsequent sale, and he points out that under §113(a)(5) of the 1939 Code the surviving tenant did not get a "stepped-up" basis for the property even though it was valued for estate tax purposes at more than its cost. 4 *Tax L. Rev.* at 30–32. Section 1014(b)(9) of the 1954 Code provides for a new basis for "property acquired from the decedent by reason of death, form of ownership, or other conditions . . . if by reason thereof the property is required to be included" in the gross estate.

GIFT TAX

COMMISSIONER v. HART

U.S. Court of Appeals, Third Circuit, 1939
106 F.2d 269

Before MARIS and CLARK, Circuit Judges, and KIRKPATRICK, District Judge.

CLARK, Circuit Judge.

This is the kind of case in which decision affords little, if any, intellectual satisfaction. It involves the application of the Act of Congress taxing gifts [§2511(a), 1954 Code], to the creation of an estate by the entireties. The words of the statute are broad and general, being: "The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." The legal circumstance is narrow and particular. It is difficult to determine the exact scope of their relationship. That difficulty is apparent in the differing conclusions reached by the various judicial officers passing upon the question.

In the case at bar, a majority of the Board of Tax Appeals have decided that the statute does not impose a gift tax on the creation of a tenancy by the entirety. The views of the dissenting members have, however, been sustained in the Seventh Circuit, *Lilly* v. *Smith*, 96 F.2d 341, certiorari denied, 305 U.S. 604. A cognate problem in the construction of the same words (involving gifts in trust with reserved power to alter but not revest in the donor) has been decided favorably to the taxpayer in the Second Circuit, *Hesslein* v. *Hoey*, 91 F 2d 954, certiorari denied 302 U.S. 756. The reasoning of this case has recently been approved and applied (under the circumstances, adversely to the taxpayer) in our own Circuit, *Sanford* v. *Commissioner*, 103 F.2d 81.* The *Hesslein* case has also been followed in *First National Bank of Birmingham* v. *United States*, D.C., 25 F.Supp. 816; and *Humphreys* v. *Rasquin*, 2 Cir., 101 F.2d 1012.† The mystery of the granting and denial of the various writs of certiorari will undoubtedly be resolved in the October 1939 Term of the United States Supreme Court.‡

There has been greater unanimity among those students of the question not holding public office. *Lilly* v. *Smith*, above cited, is endorsed by writers in 51 *Harvard Law Review* 1120 (note); 47 *Yale Law Journal* 1213 (note); 37 *Michigan Law Review* 340 (note), 17 *North Carolina Law Review* 71 (note). The endorsements are, however, somewhat argumentative, and there are two dissenting voices, 6 *Duke Bar Association Journal* 85 (note); Montgomery, *Federal Taxes on Estates, Trusts and Gifts* (1938–39) pp. 381–383. Three of these articles appeared before argument here. Counsel do not seem to attach much importance to them. At least they have not been cited, even though all discuss their efforts in the instant case.

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* Aff'd, 308 U.S. 39, *infra*, p. 1073. [Ed.]
† Aff'd, 308 U.S. 54 [Ed.]
‡ See Sanford v. Commissioner, *infra*, p. 1073.

The estate by entireties is an archaic device based upon a fiction of marital unity, "that amiable fiction of the common law," 2 *Blackstone Commentaries* 182; 1 *Jones Blackstone* 957, note 4, 1915 (we speak legally and not emotionally, although modern tendencies may make the statement seem inclusively true). So each spouse becomes seized of the whole estate from its inception. This concept of unity has been carried to its logical extreme in requiring a straw man to effectuate the conveyance of property from one spouse to himself and his spouse together, *Wright* v. *Knapp,* 183 Mich. 656, 150 N.W. 315; *Ames* v. *Chandler,* 265 Mass. 428, 164 N.E. 616; 47 *Yale Law Journal,* above cited. Pennsylvania, however, is either more practical or less logical and permits the creation of a tenancy by the entirety in the manner of the case at bar, *In re Vandergrift's Estate,* 105 Pa. Super. 293, 161 A. 898; 4 *University of Pittsburgh Law Review* 184.

The word "transfer" can and has been interpreted from either a technical or an economic aspect. In either view, we think the Treasury Regulation (79, article 2) specifically subjecting the transfer at bar to tax must prevail. The point of time at which the taxable transfer occurs in an estate by the entirety can be either at the time of its creation or at the time of the spouse's death. The selection of one or the other can and has been met on either a technical or an economic basis. The title, in a strictly legal sense, passes to both spouses, *per tout et non per my,* at the time of the estate's creation, *Lang* v. *Commissioner,* 289 U.S. 109, 53 S. Ct. 534, 77 L.Ed. 1066; 1 Washburn, *Real Property,* 6th Ed. 912; 37 *Michigan Law Review,* above cited, 4 *University of Pittsburgh Law Review,* above cited. Thus in terms of conveyancing. ". . . in examining the transfer of a full fee simple title to the 'marital unit,' one would consider the wife's acquisition a legal interest in land secured at the inception of the estate. At that time, her interest, which would be technically complete and protected by law would be equal in all respects to her husband's and, as such, would be a fit subject for a gift tax, despite the possibility of her accession to greater economic rights at her husband's death." 17 *North Carolina Law Review* 71, 73. As foreshadowed in the last sentence, it is not usually necessary to resort to any such "conceptualistic" justification to uphold the tax, 37 *Michigan Law Review,* above cited, at 341.

It is true that the wife's "use interest" does not compare in economic significance with the rights accruing to her at her husband's death. Nevertheless, in the usual case that interest is substantial, 17 *North Carolina Law Review* above cited; 30 C.J. 568. The benefits will, of course, vary with the jurisdiction. It happens that Pennsylvania goes further in the direction of chivalry than most states, 47 *Yale Law Journal,* above cited. The wife possesses the property, *McCurdy* v. *Canning,* 64 Pa. 39, shares in its rents and profits, *Gasner* v. *Pierce,* 286 Pa. 529, 134 A. 494, and may prevent its attachment for other than joint debts, *In re Meyer's Estate,* 232 Pa. 89, 81 A. 145. See generally, 4 *University of Pittsburgh Law Review,* above cited; *Madden* v. *Gosztonyi Savings & Trust Co.,* 331 Pa. 476, 200 A. 624, *Werle* v. *Werle,* 332 Pa. 49, 1 A.2d 244.

It will be noticed that we have twice employed the word "usual" in various forms. It is appropriate to use its antonym and speak of the exceptional rule at common law and in two American states, Massachusetts and North Carolina. There a wife can claim no more than a mere expectancy and the husband has exclusive control of the income and profits, *Raptes* v. *Pappas,* 259 Mass. 37, 155 N.E. 787; *Lewis* v. *Pate,* 212 N.C. 253, 193 S.E. 20. In these jurisdictions, the wife's

interest is truly based on refinements of title and, speaking economically, is frozen. By the same token, a case arising therefrom would compel the government and the courts to choose between the two theories of title and benefit. Equally, a Pennsylvania estate by the entirety meets the requirements of both and enables us to avoid the embarrassment of a declaration.

The Board of Tax Appeals in dealing with income tax has taken the "economic benefit" position, 47 *Yale Law Journal*, above cited; Paul and Mertens, *The Law of Federal Income Taxation*, section 14.04. It has held that income is returnable only by the husband in states where the common law rule prevails, *Robert C. Cooley* v. *Commissioner*, 27 B.T.A. 986, affirmed *Cooley* v. *Commissioner*, 1 Cir., 75 F.2d 188. In other jurisdictions it has allowed the income to be split between the spouses, *John H. Hart* v. *Commissioner*, 27 B.T.A. 528, affirmed *Commissioner* v. *Hart*, 6 Cir., 76 F.2d 864; *George E. Saulsbury* v. *Commissioner*, 27 B.T.A. 744; *Daniel Upthegrove* v. *Commissioner*, 33 B.T.A. 952. These rulings seem to us inconsistent with that of the case at bar. The same inconsistency appears to us to be reflected in the decisions of the Supreme Court . . .

The argument against taxability seems legislative rather than legal, and accordingly more properly addressed to the Congress than to the courts. It is pointed out, first, that the valuation of the tax depends upon the unsatisfactory calculations of mortality tables, second, that if the donee spouse predeceases her grantor, no estate tax credit * can be taken and, third, that even where credit can be taken, it does not permit of full recoupment. One of these what might be called "practical objections" does not seem sound. Mortality tables have been the legal and economic method of valuing expectancy for many years. They are based on a recognized mathematical principle of probabilities. Those who are interested in tracing the application of that principle to the precise circumstance herein may do so by consulting Wolfe, *Inheritance Tax Calculations*, at pp. 38 and 76. If there is any unfair limitation on credit, it is only as to interest, 51 *Harvard Law Review* 1120, 1121. The statutes do read as if in cases where the donee has predeceased the donor and the property has reverted to the donor, the credit could not be availed of upon the subsequent death of the donor for the purposes of his estate tax, . . . Both injustices, if they are such, can and should be removed by Congress, not by us.

The decision of the Board of Tax Appeals is vacated and the case is remanded to that Board for further proceedings not inconsistent with this opinion.

Note

1. See §2515, new in the 1954 Code. Although it is applicable to any tenancy by the entirety or joint tenancy with right of survivorship between husband and wife, so long as the subject of the tenancy is real property, the reason for its enactment is stated by the Senate Report (p 128) to be· "Many couples who elect this method of buying a home have no intention of making a gift at the time of the creation of the tenancy or any knowledge that they are considered as having done so." Note the effect, set out in §2515(b), of a termination of the tenancy. Are there circumstances when it will be to the taxpayers' advantage to elect to have the creation of the tenancy treated as a gift, as permitted by §2515(c)?

* Section 2012, *infra*, p. 1230. [Ed.]

2. When the creation of a tenancy by the entirety is subject to the federal gift tax, why does the calculation of the amount of the gift require the use of mortality tables? Would the tax be different in Massachusetts and North Carolina than in Pennsylvania? Is there a difference in respect of valuation between a joint tenancy and a tenancy by the entirety? In valuing the gift to *W*, should allowance be made for the value of *W*'s dower interest (where property subject to dower is transferred by *H* into joint tenancy or into tenancy by the entirety), for *W*'s right to support, or for depreciation likely to have been sustained in the event she acquires the property by survivorship? *Hopkins* v. *Magruder*, 34 F.Supp. 381 (D.Md. 1940), aff'd on other grounds, 122 F.2d 693 (4th Cir. 1941); noted, 54 *Harv. L. Rev.* 519 (1941); *Gutman* v. *Commissioner*, 41 B.T.A. 816 (1940). Is the annual exclusion available? See generally, Rosenberg, "Gift Taxes on Estates By the Entireties," 24 *Taxes* 965 (1946).

The method of computing the taxable gift upon creation of a tenancy by the entirety is described in *Actuarial Values for Estate and Gift Tax* (IRS Publication No. 11, 1955) 24-6.

3. Why does the Court say that if *W* predeceases *H*, there will be no estate tax credit for the gift tax paid on the conveyance? As to the shortcomings of the credit, see *infra*, p. 1230.

4. If *H* deposits funds in a joint bank account in the names of *H* and *W*, payable to either or the survivor, has he made a taxable gift? Regs. 108, Sec. 86.2(a)(4)-(6).

Section B. Gifts in Contemplation of Death: Section 2035

Internal Revenue Code of 1954

Sec. 2035. Transactions in Contemplation of Death.

(a) General Rule.—The value of the gross estate shall include the value of all property (except real property situated outside of the United States) to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death.

(b) Application of General Rule.—If the decedent within a period of 3 years ending with the date of his death (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) transferred an interest in property, . . . such transfer, . . . shall, unless shown to the contrary, be deemed to have been made in contemplation of death . . . ; but no such transfer, . . . made before such 3-year period shall be treated as having been made in contemplation of death.

Note

Since the inception of the federal estate tax in 1916, property transferred by the decedent in contemplation of death has been swept into the gross estate. From 1916 to 1950, the statute also contained a rebuttable presumption that a transfer by the decedent "of a material part of his property in the nature of a final disposition or distribution thereof," if made within 2 years of death, was a transfer in contemplation of death. The strength of the presumption was problematical, because the Commissioner's deficiencies are already *prima facie* correct, the presumption was likened to "a handkerchief thrown over something covered by a blanket also." Paul, *Federal Estate and Gift Taxation* (1946 Supp.), p. 92.

In 1926, when the 1924 federal gift tax was repealed (*supra*, p. 908), an irrebuttable presumption of transfer in contemplation of death was added to the estate tax law, applicable to gifts within 2 years of death, to the extent in excess of $5,000 per donee Three days later, the Supreme Court (Holmes, Brandeis, and Stone dissenting) held that a similar Wisconsin statute (as to gifts within six years of death) was in violation of the Fourteenth Amendment. *Schlesinger* v. *Wisconsin*, 270 U.S. 230 (1926). Mr.

Justice McReynolds, writing for the Court, could find "no adequate basis" for distinguishing gifts made within the statutory period from those made outside it, as for the anti-evasion function of the presumption, he found it to be an unconstitutional attempt to subject "'A' . . . to an exactment forbidden by the Constitution if this seems necessary in order to enable the State readily to collect lawful charges against 'B.'" In 1932, the Court held that the federal presumption of 1926 was forbidden by the Fifth Amendment over a strong dissent by Stone and Brandeis (Cardozo not participating), which analyzed in detail the government's factual and legal arguments in support of the presumption. *Heiner* v. *Donnan*, 285 U.S. 312 (1932). Following this decision, the irrebuttable presumption was repealed. As to the present vitality of *Heiner* v. *Donnan*, see Paul, 1 *Fedral Estate and Gift Taxation*, Sec. 6.26.

Throughout the period 1916–50, transfers made outside the presumptive period could be included in the gross estate if, without recourse to the presumption, they were made in contemplation of death. In 1950, however, the final clause of what is now §2035(b) was enacted, providing that gifts made more than 3 years before death may not be included in the gross estate as gifts in contemplation of death. At the same time, the language of the rebuttable presumption was given in its present form, and the period to which it applies was extended from 2 to 3 years. The Senate Finance Committee (S. Rept. No. 2375, 81st Cong., 2d Sess., 50–2 C.B 524–5) explained the change as follows:

> While the inclusion in the gross estate of transfers in contemplation of death has long been regarded as necessary to prevent avoidance of the estate tax, the administration of this feature of the estate tax law has always proved difficult. Principally this is due to the fact that contemplation of death deals with the intent of the transferor. Intent is extremely difficult to establish in any case and becomes increasingly so with the passage of time. Undoubtedly many gifts in contemplation of death have escaped the estate tax because of the difficulty which the Government encounters in reconstructing the motives of the deceased. On the other hand, complaints have been received that the Bureau of Internal Revenue has in some cases asserted that gifts made many years before death were in contemplation of death without having much basis for the assertion. As a result executors of estates are confronted with an unpleasant choice between compromising the asserted tax liability or engaging in expensive and difficult litigation. At the present time this problem hangs over any person who makes a gift, even though he expects to live for many years, unless he can prepare evidence demonstrating that the gift was made primarily for nontax reasons.
>
> Section 501 of your committee's bill removes from the scope of the contemplation of death clause all transfers made more than 3 years prior to the date of death. On the other hand, the burden of showing that the transfer was not in contemplation of death will be borne by the estate in all cases where the transfer was made within a period of 3 years ending with the date of death. This will strengthen the position of the Government in cases where the transfer occurred between 2 and 3 years prior to the date of death.
>
> The change will be effective only with respect to the estates of decedents dying after the date of enactment of this bill. It is estimated that this provision will reduce the revenues by about $4,000,000 a year when in full operation.

UNITED STATES v. WELLS

Supreme Court of the United States, 1931
283 U.S. 102

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

[Court's statement of facts is omitted.]

The Court of Claims did not find, in terms, that the transfers in question were

not made in contemplation of death, but it is evident that the court considered that its findings of fact amounted to that in substance, in view of the conclusion of law, based upon these findings, that the executors were entitled to recover the additional tax. This is also manifest from the reasoning of the court's opinion. The court said [p. 513].

The plaintiffs have not only overcome the [rebuttable 2-year] presumption . . . that the transfers were made in contemplation of death but have definitely established the fact that the immediate and moving cause of the transfers was the carrying out of a policy long followed by decedent in dealing with his children of making liberal gifts to them during his lifetime. He had consistently followed that policy for nearly thirty years and the three transfers in question were a continuation and final consummation of such policy. In the last transfer such amounts were given to his children as would even them up one with another, in the gifts and advancements made to them.

That this was the motive which actuated the decedent in making these transfers seems unquestioned. He repeatedly, in letters to his children and in statements to business associates at about the time the transfers were made, gave this as his reason for such transfers.

After the final transfer in which the advancements and gifts to the children were evened up in January, 1921, the decedent still possessed property of the value of nearly $900,000, from which he drew an annual income of approximately $50,000. At the time the transfers were made, decedent had no reason to believe otherwise than [that], aside from his asthma, he was, for a man of his age, in ordinary health. While he had gone through a most serious and painful illness, he had, as he believed, made an almost complete recovery. He was assured of this fact by his physician, an eminent specialist, in whom he had great confidence. The repeated statements made to him by close friends and associates, his daily activities in matters connected with his business affairs, his letters to his children assuring them of his renewed health, show that he fully believed the assurances given him by his physician that he was cured and had nothing to fear on account of his former illness.

The presumption created by the statute that the transfers in question were made in contemplation of death can not stand against ascertained and proven facts showing the contrary to be true. The best evidence of the state of the decedent's health at the time the transfers were made is the statement of his doctor The best evidence of the decedent's state of mind at that time and the reasons actuating him in making the transfers are the statements and expressions of the decedent himself, supported as such statements are by all the circumstances concerning the transfers.

The Government contests the decision of the Court of Claims upon the ground that the conclusion was reached by an erroneous construction of the words "in contemplation of death" as used in the statute. The court held that " 'contemplation of death' does not mean that general knowledge of all men that they must die, but that there must be a present apprehension, from some existing bodily or mental condition or impending peril, creating a reasonable fear that death is near at hand, and that such reasonable fear or apprehension must be the direct or animating cause, and the only cause of the transfer." The Government insists that this definition is too narrow; that transfers in contemplation of death are not limited to those induced by a condition causing expectation of death in the near future; that the character of such gifts is determined by the state of mind of the donor at the time they are made, and that the statutory presumption may be overcome only by proof that the decedent's purpose in making the gift was to attain some object desirable to him during his life, as distinguished from the distribution of his estate as at death.

The phrase "in contemplation of death," previously found in state statutes, was first used by the Congress in the Revenue Act of 1916, imposing an estate tax.* It was coupled with a clause creating a statutory presumption in case of gifts within two years before death. The provision was continued in the Revenue Act of 1918, which governs the present case, and in later legislation. While the interpretation of the phrase has not been uniform, there has been agreement upon certain fundamental considerations. It is recognized that the reference is not to the general expectation of death which all entertain. It must be a particular concern, giving rise to a definite motive. The provision is not confined to gifts *causa mortis*, which are made in anticipation of impending death, are revocable, and are defeated if the donor survives the apprehended peril. *Basket* v. *Hassell*, 107 U.S. 602, 609, 610. The statutory description embraces gifts *inter vivos*, despite the fact that they are fully executed, are irrevocable and indefeasible. The quality which brings the transfer within the statute is indicated by the context and manifest purpose. Transfers in contemplation of death are included within the same category, for the purpose of taxation, with transfers intended to take effect at or after the death of the transferor. The dominant purpose is to reach substitutes for testamentary dispositions and thus to prevent the evasion of the estate tax. *Nichols* v. *Coolidge*, 274 U.S. 531, 542; *Milliken* v. *United States*, 283 U.S. 15. As the transfer may otherwise have all the indicia of a valid gift *inter vivos*, the differentiating factor must be found in the transferor's motive. Death must be "contemplated," that is, the motive which induces the transfer must be of the sort which leads to testamentary disposition. As a condition of body or mind that naturally gives rise to the feeling that death is near, that the donor is about to reach the moment of inevitable surrender of ownership, is most likely to prompt such a disposition to those who are deemed to be the proper objects of his bounty, the evidence of the existence or non-existence of such a condition at the time of the gift is obviously of great importance in determining whether it is made in contemplation of death. The natural and reasonable inference which may be drawn from the fact that but a short period intervenes between the transfer and death, is recognized by the statutory provision creating a presumption in the case of gifts within two years prior to death. But this presumption, by the statute before us, is expressly stated to be a rebuttable one, and the mere fact that death ensues even shortly after the gift does not determine absolutely that it is in contemplation of death. The question, necessarily, is as to the state of mind of the donor.

As the test, despite varying circumstances, is always to be found in motive, it cannot be said that the determinative motive is lacking merely because of the absence of a consciousness that death is imminent. It is contemplation of death, not necessarily contemplation of imminent death, to which the statute refers. It is conceivable that the idea of death may possess the mind so as to furnish a con-

* The phrase first appeared in the New York Inheritance Tax Law of 1891 (Laws, 1891, c. 215, §1), and was early held to apply only to gifts *causa mortis*. Matter of Seaman, 147 N.Y. 69, 41 N.E. 401 (1895). The phrase soon found its way into the statutes of other states; by the time it appeared in the Revenue Act of 1916, it was generally held by state courts (including New York, in effect if not explicitly) not to be restricted to gifts *causa mortis*. Annotations, 18 L.R.A. (N.S.) 458 (1909); 46 *Ibid.* 790 (1913); 7 A.L.R. 1028, 1030 (1920). [Ed.]

trolling motive for the disposition of property, although death is not thought to be close at hand. Old age may give premonitions and promptings independent of mortal disease. Yet age in itself cannot be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than with death, may motivate the transfer. The words "in contemplation of death" mean that the thought of death is the impelling cause of the transfer, and while the belief in the imminence of death may afford convincing evidence, the statute is not to be limited, and its purpose thwarted, by a rule of construction which in place of contemplation of death makes the final criterion to be an apprehension that death is "near at hand."

If it is the thought of death, as a controlling motive prompting the disposition of property, that affords the test, it follows that the statute does not embrace gifts *inter vivos* which spring from a different motive. Such transfers were made the subject of a distinct gift tax, since repealed. As illustrating transfers found to be related to purposes associated with life, rather than with the distribution of property in anticipation of death, the Government mentions transfers made "for the purpose of relieving the donor of the cares of management or in order that his children may experience the responsibilities of business under his guidance and supervision." The illustrations are useful but not exhaustive. The purposes which may be served by gifts are of great variety. It is common knowledge that a frequent inducement is, not only the desire to be relieved of responsibilities, but to have children, or others who may be the appropriate objects of the donor's bounty, independently established with competencies of their own, without being compelled to await the death of the donor and without particular consideration of that event. There may be the desire to recognize special needs or exigencies or to discharge moral obligations. The gratification of such desires may be a more compelling motive than any thought of death.

It is apparent that there can be no precise delimitation of the transactions embraced within the conception of transfers in "contemplation of death," as there can be none in relation to fraud, undue influence, due process of law, or other familiar legal concepts which are applicable to many varying circumstances. There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute.

We think that the Government is right in its criticism of the narrowness of the rule laid down by the Court of Claims, in requiring that there be a condition "creating a reasonable fear that death is *near at hand*," and that "*such* reasonable fear or apprehension" must be "the only cause of the transfer." It is sufficient if contemplation of death be the inducing cause of the transfer whether or not death is believed to be near. But it does not appear that the decision of the court rests upon the limitation thus expressed. The court did not rely merely upon the fact that at the time of the transfers decedent considered that he had recovered from his former illness and believed the assurances given him by his physician that he need have no fear of its recurrence or any "anxiety whatever about his state of health." That fact was manifestly important, but, in addition to that, the court held that "the immediate and moving cause of the transfers was the carrying out of a policy, long followed by decedent in dealing with his

children, of making liberal gifts to them during his lifetime." The court regarded the transfers in question as "a continuation and final consummation of such policy," saying "that this was the motive which actuated the decedent in making these transfers seems unquestioned." In the view of the court as thus explicitly stated, not only was there no fear at the time of the transfers that death was near at hand, but the motive for the transfers brought them within the category of those which, as described by the Government, are intended by the donor "to accomplish some purpose desirable to him if he continues to live." In the presence of such a motive, appropriately found, and of the underlying facts which have been expressly found, there would be no ground for a reversal of the judgment merely because of an inaccuracy in the general statement as to the meaning of the statutory phrase.

The only difficulty presented by the record is that this statement with respect to the motive of decedent appears in the opinion of the court and not in its findings of fact. We are not at liberty to refer to the opinion for additional findings. The findings of fact of the Court of Claims are to be treated like the verdict of a jury. We cannot add to them, or modify them, but the absence of the finding of an ultimate fact does not require a reversal of the judgment if the circumstantial facts as found are such that the ultimate fact follows from them as a necessary inference.

It is evident that the court did not consider the statements in its opinion, which we have quoted, as additional findings of fact, but as an argument with respect to the conclusion to be drawn from its findings. In its opinion, the court was summarizing what it considered to be the effect of its findings, and no useful purpose would be served in returning the case for a specific finding that the motive which impelled the decedent to make the transfers was precisely that which the court has thus definitely stated. While, in accordance with proper practice and the rule of this Court, the Court of Claims should have found the ultimate fact, and we do not approve the method it adopted, we are of the opinion that, in view of the findings of fact actually made and the conclusion they import, the judgment should be sustained.

Judgment affirmed.

MR. JUSTICE ROBERTS took no part in the consideration or decision of this case.

ESTATE OF OLIVER JOHNSON v. COMMISSIONER

Tax Court of the United States, 1948
10 T.C. 680

The Commissioner determined a deficiency of $44,765.91 in estate tax liability. The value of the gross estate was determined in part by including the value of property transferred by the decedent during his lifetime. The sole issue for decision is whether such property was transferred in contemplation of death within the meaning of § 811(c) of the [1939] Internal Revenue Code. Other adjustments made by respondent are not here in issue. The parties have stipulated that certain costs and expenses incurred by the decedent's estate may be allowed as deductions in computations to be made pursuant to Rule 50.

Findings of Fact

The parties have filed a stipulation of facts which is incorporated herein by reference.

The decedent, Oliver Johnson, died March 8, 1943, at the age of 94 years, a resident of Long Beach, California. He was survived by 5 children: C. Elmer Johnson, Alla J. Ross, Bertha J. Landreth, T. Leman Johnson, and Bula J. Simms. The children ranged between the ages of 50 and 68 at the date of decedent's death. The executrix of the estate is Alla J. Ross. The estate tax return was filed with the collector of internal revenue for the sixth district of California.

The decedent was born in Iowa on November 4, 1848. He was one of nine children, four of whom were alive in 1939. In 1878 he became a resident of Belleville, Kansas. In 1905 he moved to Courtland, Kansas, where he remained until 1918. During decedent's residence in Kansas he was primarily a farmer. He acquired 9 tracts of farm lands between 1883 and 1916, containing a total of 1,487½ acres in Republic County, Kansas. Two of these tracts were improved with a house and barns; 2 others with a house each Sometime prior to 1918 the decedent placed the active farming of these properties with tenants. He also made loans on notes and mortgages. For a short time before the first World War he owned a controlling interest in a small bank in Courtland, Kansas.

In 1918 the decedent and his wife decided to leave Kansas in order to escape the cold weather and move to California, where they had wanted to live and where they could be out of doors more often. Pursuant to their decision, they sold all of their household effects and set out for California by way of Wenatchee, Washington, where one or more of their children lived. They spent the winter in Washington and moved to Long Beach, California, in 1919.

The decedent arrived in Long Beach, California, shortly prior to his seventy-first birthday. He considered himself a retired farmer, but he retained an active interest in his farm properties. He returned to Kansas virtually every year during four or five months in the summer and fall of each year until 1939. During these months he inspected his farms, transacted business, and visited friends. In 1920 the decedent bought a house in Long Beach for himself and his wife. He acquired one other house in 1921 and in 1925 purchased a two-story office building in Corona, California, in which his daughter Bula and her husband operated a drug store.

In 1927 the decedent's wife died. The decedent purchased crypts for himself and his wife in the Sunnyside Mausoleum of Long Beach. The decedent then lived with his son Elmer for approximately one year. Thereafter he lived alone in rented rooms during the winters until 1937. In that year he purchased the Oliver Apartments in Long Beach, where he kept an apartment for himself until he moved to the home of his daughter Alla in August of 1940.

Prior to 1932 the decedent made a number of loans, usually at 6 per cent interest and secured by trust deeds and mortgages on real estate in California. These loans were made through the Golden State Bond & Mortgage Co. In 1932 the Golden State Bond & Mortgage Co. became financially embarrassed. Between 1932 and 1934 the decedent acquired the outright ownership of 21 or more small rental properties because of defaults on the loans he had made. In each case the decedent paid something for the equity and received deeds from

the owners. In each case the title to these properties was encumbered by local tax and other municipal liens.

Between 1934 and 1939 the decedent owned a total of 28 or more properties in Southern California, some of which were occupied by more than one tenant. Rent collections, repairs, and clearing of the titles required the work of 2 men. The decedent, who was 85 years of age in 1933, worked from 9 in the morning until 4·30 or 5 o'clock at night, 4 and 5 days a week. In 1933 the decedent hired his son Elmer as a full time employee at a salary of $350 a month. This salary was raised to $400 a month for the first 6 months in 1939. Elmer furnished transportation, acted as bookkeeper, and filled out the decedent's tax returns for the years 1930 to 1939 inclusive. The decedent had not owned an automobile since 1918 and had never filled out his own tax return. The decedent kept some accounts in a pocket notebook and retained his bank statements. When the decedent returned to Kansas each year the management of the Long Beach properties was carried on by Elmer. Bula J. Simms and her husband collected the rents on the Corona property. Elmer and Bula were authorized to and did make deposits on behalf of the decedent in bank accounts he maintained in Long Beach and Corona, respectively.

Prior to 1939, the decedent had stated several times that he did not like small rental properties. He had so stated when a real estate broker attempted to interest him in such properties. In 1933 he told his daughter Bula that he was going to have to take active management of such properties, due to the failure of the mortgage company. He stated that he never liked the management and intended to give the properties to his children as soon as he could clear up the titles. He told the same thing to his son Leman in 1935, saying that when the titles were clear he was going to make a division of those properties for his children so that he could see them enjoy the properties while he was still alive. He was desirous of making an equal division and one that would satisfy the children. He had told Elmer of his intentions about the property division on several occasions.

The last encumbrance was cleared away in late 1938. A few days prior to March 3, 1939, the decedent told his daughter Bertha and her husband, who were then visiting in Long Beach, that he had a surprise which he thought would make all the children happy. The decedent had itemized gifts of his real property for all the children, saying that he had always intended making the gifts but had never before had them in the proper shape, free and clear of encumbrances. He stated that he wanted the children to look over these properties in order to make a division that would satisfy all of them. The three of them then drove to Corona to tell his daughter Bula.

The next morning the decedent stated that he wanted the children to know why he was making the gifts of his real property. He said that he did not want them to think that he was not going to live very long because he expected to live a long time. He stated that he did not think he wanted to go back to Kansas again and that he did not want to be bothered with the rental properties. He said that he would keep his notes and mortgages and would therefore never have to go to his children for care. Thereafter the party returned to Long Beach and made a tour of the Long Beach properties with his son Elmer. A short time later an attorney was given a description of the properties and told to draw up the

deeds, which the decedent signed on March 3, 1939. Two of the decedent's children were not present in Long Beach when the gifts were made.

The gifts consisted of all the decedent's real properties. At the date of the gifts the decedent owned 9 Kansas farms, and each of the children received at least one tract. The Corona property was given in equal, undivided shares to Bertha and Bula. The latter took title jointly with her husband. The remaining 21 properties which the decedent had acquired between 1932 and 1934, in addition to 6 properties which he had purchased outright, all located in Long Beach, were divided among all of the children. There was an oral condition to the gift. Extensive repairs and alterations had been undertaken on the Corona property. The parties orally agreed that all the rentals from the Long Beach properties would be applied on the cost of the Corona repairs until July 1, 1939. This was done. Thereafter the decedent took no part in the management of any of the real property.

The decedent had valued all his real property at $175,000 and divided it so that each child received property valued at $35,000. Three children requested that title be given to them jointly with their respective spouses. As a result, the decedent claimed exclusions of $32,000 and an exemption of $40,000 on his gift tax return filed on January 30, 1940. The tax paid amounted to $7,582.50. As the result of an audit by the Bureau of Internal Revenue the total valuation of the gifts was increased to $203,900, and an additional tax of $3,684.75 was later paid. The agreed value of the property at the date of decedent's death in 1943 was $255,950.

At the date of the gift the decedent retained notes and obligations executed by 17 parties, ranging in amounts between $49.10 and $21,000, which had an aggregate value of $43,255.21. All of these obligations paid 6 per cent interest with the exception of one or two of the smaller ones. The decedent also retained $6,178.64 in cash, of which $3,806.62 was in a savings bank in Los Angeles and the balance was in banks in Corona and Long Beach. The total property retained had an actual value of $49,433.53 at the date of the gift.

The decedent's age at the date of the gift on March 3, 1939, was 90 years and 4 months. He lived moderately and inexpensively. He lived in single rooms and ate at small restaurants. He bought ready-made clothes, and liked bright-colored neckties. He had no expensive pastime or hobby. He had stated that he knew how to make money, but had never learned to spend it. In April of 1939 his daughter Alla moved into the Oliver Apartments which the decedent had given her on March 3, 1939. The decedent, who had lived there since 1937, began taking his meals from her. He paid her $25 a month for his room and $75 for meals and transportation. This latter amount was raised to $100 a month in 1941. The expenses of the decedent were not in excess of approximately $150 a month. The decedent reported in his income tax returns the following net income.

1936	$4,894.29	1940	$2,337.90
1937	8,869.02	1941	2,047.48
1938	5,458.06	1942	1,664.79
1939	5,718.13		

The decedent was independent of his family. He did not like to have his

affairs handled by lawyers. He pursued his own hobbies. He liked to walk, ran his own errands, and regularly covered on foot the 9 blocks from his room to church alone. On one occasion in 1940 he walked some 70 blocks, accompanied by his daughter, in order to go to the bank, visit friends, and have dinner in downtown Long Beach. He walked as fast as anyone. He was erect and had a young man's carriage.

The decedent also liked to travel. Each year from 1928 to 1939 he traveled alone to Kansas for the purpose of overseeing his farms, and to many other states in order to visit friends and relatives. During these visits he was in the habit of corresponding with various members of his family. Numerous letters of decedent were introduced in evidence and are incorporated herein by reference. Their tone is cheerful, alert, and businesslike. The following is a typical example·

Courtland, Kansas, August 6, 1938

Mr. & Mrs. Grant and Bula
Corona, Calif.

Your good letter came to hand this day and I am pleased to hear the news. I will try to answer this time. Yes, I have been busy and over the river part of the time. But I will be done next week. The rains kept people out of the fields so much and we couldn't help that, see? All done but Orin Reid and Dan Rickle and he will finish next week. I hope he will finish my 60 acres. He will put my share with his and sell it for oatmeal and get a better price in that way. The wheat was not worth much this year, the corn over there is sure fine, plenty roasting now. But I fear corn will be cheap, only 40 cts. now. I sold the old corn for that price except one load I sold part at 50 cts. I am pleased that you went to Church and glad that Brother Gordon can go to Church. I am pleased with the tone of your letter, so much news to hear. I would be pleased to hear often, then I could answer often. Try it once.

As ever,
Oliver Johnson

Cousin Till Warner is very sick, had two strokes. No hope for her.

O.J.

The decedent liked to call on his children unexpectedly and some of his visits were as early as 7 o'clock in the morning. He occasionally took the bus to Corona, California, to visit his daughter Bula. In the fall of 1939 the decedent made a 2-day trip by automobile to Boulder Dam and Death Valley, a distance of 800 miles, with members of his family. In 1940 the decedent returned to Long Beach with a son-in-law after a visit in Washington. On one occasion the party motored approximately 700 miles in one day and spent the next 2 days walking through the San Francisco Fair before they returned to Long Beach. On the occasion of the 700-mile drive decedent sat in the back seat and urged his son-in-law to drive faster. The decedent suffered no effects from these trips.

The decedent was proud of his vigor and physical appearance. He weighed approximately 145 pounds. At one time in 1938, in order to demonstrate his agility, he jumped into the air and clicked his heels together 2 or 3 times before descending to the floor. In getting up from a chair at all times pertinent hereto he would stand up straight without touching the arms of the chair. He regarded himself as younger than other old men not yet his age and would comment with ridicule upon their elderly appearance. He frequently stated that he expected to live to be a hundred years old. He appeared 12 to 15 years younger than he

actually was and regarded himself as a younger man. He had a full head of hair, which was iron gray. He was cheerful by nature and kept himself busy. The decedent was mentally alert and knew his business affairs.

He was active in church affairs. He was a member of the Church of Christ, which he attended regularly three times a week. In addition to visiting, walking, and church-going, he pursued the hobbies of horseshoe pitching and woodworking. He had an expert's skill in horseshoe pitching, making a large percentage of ringers. The woodworking was usually done in the decedent's rooms. He constructed such items as cupboards and footstools.

On or about June 5, 1939, the decedent wrote, dated, and executed in his own hand his last will:

Long Beach, California, June 5th, 1939.

I, Oliver Johnson, a widower, hereby made [sic] my last will. I revoke all wills by me heretofore mad [sic]. I give all my property both real and personaly [sic], all bonds, stocks, and mortgages of which I die possessed to my five children named. C. Elmer Johnson, Alla J. Ross, Bertha J. Landreth, Leman Johnson, and Bula J. Simms. I appoint my daughter, Alla J. Ross, as Executrix of this will without bond, without help of lawyer or attorney and without order of court or judge.

It is my will that the above named, who are all my own children [sic] come together by themselves, after my death and divide it eagrable [sic] between them. Each child must settle his account with the estate so that it will be equal. I declare this is entirely written [sic] dated and signed by my own hand.

In 1934 the decedent had a mild case of pneumonia, for which a doctor's services were required. The services of a nurse were not required. Between 1927 and 1939 the decedent occasionally visited doctors for mild complaints in the nature of colds, stomach aches, and lightheadedness. The decedent did not use glasses and did not use a hearing aid, although his hearing was impaired. In 1938 or 1939 the decedent visited Dr. Bradford, a chiropractor, complaining of a stomach ache and light-headedness. The decedent told Dr. Bradford that he had been to a doctor who told him that he had high blood pressure. The chiropractor found a constriction around the decedent's stomach and liver which he attributed to dietary habits. After 12 to 15 treatments for a month or 6 weeks, the condition was corrected. The chiropractor had the opinion that nothing was organically wrong with the decedent. He found the patient to be remarkably preserved, mentally alert, and very spry.

On four occasions, August 23 and September 23, in 1940, and January 22 and 26 of 1941, the decedent was visited by Dr. Hoover, a medical practitioner, of Long Beach. On each of these occasions the decedent complained of pains in the abdomen. The doctor was of the opinion that the pains were the result of poor circulation, which in turn was traceable to auricular fibrillation. Auricular fibrillation is a condition which is caused by a deterioration or aging of the heart and is manifest through an irregular beating of the auricles of the heart. The damage to the heart develops gradually over a long period of time, but the noticeable irregularity appears without warning. The irregularity has the effect of impairing the efficiency of the circulation. By administering digitalis the heart action is slowed and the heart operates more efficiently. On at least three of the doctor's visits, digitalis was prescribed.

On January 20, 1941, the decedent gave one of his daughters a general power

of attorney. The decedent's health notably failed in the latter part of 1942 and the early part of 1943. His daughter Alla, with whom the decedent lived, became ill. She could not give the care that the decedent needed and therefore the decedent was moved to the Los Alamitos Sanatorium 2 months before he died. The immediate cause of the decedent's death on March 8, 1943, was acute congestive heart failure of one day's duration and bronchopneumonia of 10 days' duration. Senility was listed as an "other condition."

Between 1900 and 1916 the decedent gave each of his children a gift which he evaluated at $2,400 to $2,500. Elmer received a wagon and team and a half interest in a hardware store where he worked. An indebtedness of Leman was canceled in 1913. Bula received a house and lot when she was married. After 1929, pursuant to his deceased wife's request, the decedent gave each of his children a one-fifth share in a note executed by Landreth Brothers of Wenatchee, Washington. The principal of the note had been advanced after 1918 or 1919. The principal and accrued interest thereon amounted to approximately $100,000. Apparently, since the date of the gift $10,000 to $12,000 has been realized on each one-fifth share.

At other times the decedent gave pianos to two of the children and equivalent gifts to the other three. He gave footstools to each child. He had also given Chinese coats to the daughters and suits to the sons.

The decedent's dominant motive in making the gifts in question was to rid himself of the active management of the property transferred. The transfers were not made in contemplation of death.

Opinion

KERN, Judge.

The sole question is whether the value of the transfers of March 3, 1939, should be included in the gross estate of the decedent according to the provisions of section 811(c) of the [1939] Internal Revenue Code.

The ultimate question to be decided in this case, as in others arising under the quoted statute, is whether the dominant or impelling motive of decedent in making these transfers was associated with death and was prompted by the thought of death.

This question is a subjective one. It concerns the motives and mental processes of a particular human being, in this case one Oliver Johnson, who made the transfers in question more than 10 years before the hearings were held in this proceeding and who died more than 4 years before those hearings.

Among the circumstances to be considered and weighed in determining what was the dominant motive of the decedent in making *inter vivos* transfers of his property, are the following. (a) The age of the decedent at the time the transfers were made; (b) the decedent's health, as he knew it, at or before the time of the transfers; (c) the interval between the transfers and the decedent's death; (d) the amount of the property transferred in proportion to the amount of property retained; (e) the nature and disposition of the decedent, *e.g.*, whether cheerful or gloomy, sanguine or morbid, optimistic or pessimistic; (f) the existence of a general testamentary scheme of which the transfers were a part, (g) the relationship of the donee or donees to the decedent, *i.e.*, whether they were the natural

objects of his bounty; (h) the existence of a long established gift-making policy on the part of decedent; (i) the existence of a desire on the part of the decedent to escape the burden of managing property by transferring the property to others, (j) the existence of a desire on the part of the decedent to vicariously enjoy the enjoyment by the donees of the property transferred; and (k) the existence of the desire by the decedent of avoiding estate taxes by means of making *inter vivos* transfers of property. This is not a comprehensive list of the circumstances pertinent to the problem of what transfers are made in contemplation of death, but it includes most of the circumstances and considerations pertinent to the instant case.

Of these circumstances, some are favorable to respondent's contentions that the transfers were made in contemplation of death, and some are favorable to the position of petitioner that decedent's motives in making the transfers were associated with life rather than with death.

Those circumstances which tend to indicate that decedent's motives in making the transfers were associated with death are as follows: (a) The advanced age of decedent when he made the transfers; (b) the amount of the property transferred by decedent in proportion to the amount of property retained by him; and (c) the fact that the donees were all the children of decedent, the natural objects of his bounty and the legatees in his subsequently executed will.

The circumstances which tend to indicate that decedent's motives were associated with life are as follows: (a) Decedent's health at or before the time of the transfers was good, (b) decedent's nature and disposition were cheerful, sanguine, and optimistic; (c) there was an interval of four years between the time of the transfers and the time of decedent's death; (d) there was at the time of the transfers no testamentary scheme on the part of decedent, decedent's only will (so far as the record discloses) having been made four months after the transfers; (e) the decedent had over a long period of time made gifts to the same donees and in the same proportions as to each other; and (f) the decedent desired to escape the burdens incident to the management of the properties transferred.

The evidence is not compelling as to two pertinent circumstances, *viz*, the desire of the decedent to derive pleasure from the enjoyment by his children of the property transferred to them, and his desire to save estate taxes by such transfers. The record as a whole, however, justifies the inference that decedent did derive pleasure from the enjoyment by his children of the property transferred to them, and that decedent was in no way interested in the saving of estate taxes.

With regard to the three circumstances which tend to favor respondent's contention, two of them are subject to minimizing qualifications. While the amount of the property transferred by decedent was large in proportion to the amount retained by him, nevertheless, the amount of property retained was enough in his judgment to support him in the frugal manner of living to which he was accustomed and which he evidently preferred. While the donees were his children and, as such, the natural objects of his testamentary bounty, they were also for the same reason the natural objects of his donative bounty.

With regard to the circumstances tending to favor petitioner's contention, many of them are subject to amplification. For example, to say that decedent's health was good seems inadequate in view of the testimony concerning his health

given by respondent's own witness, a chiropractor who gave treatments to decedent over a period of approximately a month in 1938 or 1939. He testified that decedent was "wonderfully preserved for a man of his age," that "he didn't look his age by 12 or 15 years," that he was "a jolly old fellow," very alert and very spry, that he was active and carried himself like a young man, that after his treatments "his troubles seemed to be all over," and that he said "he was going to be here a long time." It is impossible to read the record here without concluding that the decedent in 1939 was, and had been, in extraordinarily good health; and, further, that he took an almost childish pride in his health and vigor.

The evidence is also most convincing in regard to decedent's desire to escape the burdens incident to the management of the properties transferred. The testimony of decedent's children that he had on several occasions made statements that he did not like the care of rental properties and wished to give them away as soon as he could clear the properties from liens is credible in the light of the facts. A retired farmer, 85 years old, enjoying his old age in Southern California, who was suddenly faced during the depression years with the necessity of managing a substantial number of rental properties and thus sacrificing his horseshoe pitching and woodwork, would most naturally have a desire to get rid of this unwanted responsibility as soon as he felt it possible for him to do so. Having gone through the vexing and trying experience of managing a large number of rental properties for some five years, it was natural for him to feel a revulsion against a continued responsibility for any rental property and to add the few rental properties which he had acquired prior to 1932 to the properties which he desired to transfer. And his decision in 1939 to include in the transfers of properties his farms in Kansas was consistent with a desire to shed responsibilities and concentrate on the pleasure of living. For a man 90 years of age to prefer to remain in Southern California with his family and his hobbies rather than to go during the summer months to the Kansas wheat country is a decision which would more reasonably result from considerations in regard to a pleasant place for living than from considerations in regard to death.

Certain evidence indicates that the children of decedent desired him to make the transfers in question. It is quite possible that *their* motives in desiring him to do so were associated with his death and were caused by *their* contemplation of his death, but their motives are irrelevant unless it is shown that decedent's will was substantially subordinated to theirs. The record indicates, however, that decedent's will was independently his.

Were it not for the decedent's advanced age at the time of the transfers here in issue, we would have little difficulty in concluding that the transfers were not made in contemplation of death. The one evidentiary circumstance as to which respondent stands on firm ground is that decedent at the time of the transfers was an old man, indeed an unusually old man.

It may be that the norm for the consideration of the mind and motives of a man 90 years of age is that of a man weakened by senility and subject to the continual and unmistakable physical intimations of approaching disintegration, with a consequent concentration on the spiritual and material problems posed by death.

If that is the norm, then we are convinced by the evidence before us that

the decedent was not normal. The record in this case portrays an old man of far different characteristics. He was an old man of amazing vigor who enjoyed "showing off" that vigor to his children and friends (frequently to their annoyance). He was alert and independent, cheerful, and interested in living, and, above all, proud of his vitality and comparative youthfulness.

This portrait may not be an accurate likeness of the real Oliver Johnson. It is possible that the verbal picture of Oliver created at the trial by the testimony of witnesses brought out by the skillful guidance of petitioner's counsel emphasized certain of his features and left others in shadow to the extent that the Oliver Johnson of the verbal portrait has more resemblance to a synthesis of decedents whose transfers had been held in many reported cases to have been made not in contemplation of death than to the real Oliver Johnson who transferred real estate in Southern California on March 3, 1939.* But the judicial process requires that we create our image of Oliver from the material in the record before us. We can not be certain that our portrait of Oliver is a lifelike replica of the real Oliver, but we are confident that it accurately reflects the portrait of Oliver drawn by the evidence in this record.

When old age has brought with it to a decedent the normal results, that is, physical illnesses and mental preoccupation with mortality, old age may be a decisive test in determining whether transfers made by the decedent were prompted by thought of death. But where old age has not brought with it to a decedent these normal results, ". . . age in itself can not be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than death, may motivate the transfer." *United States* v. *Wells*, 282 U.S. 102.

To quote again from the *Wells* case·

If it is the thought of death, as a controlling motive prompting the disposition of property, that affords the test, it follows that the statute does not embrace gifts *inter vivos* which spring from a different motive. . . . As illustrating transfers found to be related to purposes associated with life, rather than with the distribution of property in anticipation of death, the Government mentions transfers made "for the purpose of relieving the donor of the cares of management or in order that his children may experience the responsibilities of business under his guidance and supervision." The illustrations are useful but not exhaustive. The purposes which may be served by gifts are of great variety. It is common knowledge that a frequent inducement is not only the desire to be relieved of responsibilities, but to have children, or others who may be the appropriate objects of the donor's bounty, independently established with competencies of their own, without being compelled to await the death of the donor and without particular consideration of that event. There may be the desire to recognize special needs or exigencies or to discharge moral obligations The gratification of such desires may be a more compelling motive than any thought of death.

In the instant case we have concluded from all the evidence that in spite of decedent's unusually advanced age the dominant and impelling motive of decedent in making the transfers here involved was not the thought of death, but was the

* In *Galt* v. *Commissioner*, 216 F.2d 41 (7th Cir. 1954), the court quotes a letter written by the taxpayer to his sons on giving them certain interests in sums to become due under a lease. One paragraph of the letter reads as follows: "I am now in my sixties and never felt better or was in better health in my life than I am at this date, and as I come from a long lived family—my father having died at about ninety-two, I fully expect to live during the entire life of the lease [20 years], and share with you the fullest association of our mutual company." [Ed.]

desire to escape the burdens incident to the management of the properties transferred. Therefore our decision on the issue submitted is that the transfers were not made by decedent in contemplation of death.

Reviewed by the Court.

Decision will be entered under Rule 50.

VAN FOSSAN, MURDOCK, and ARNOLD, JJ., concur only in the result. TURNER, J., dissents.

Note

1. This case, unimportant in itself, illustrates the variety of evidence that may be introduced in a contemplation of death case. See Atlas, "Gifts in Contemplation of Death," 23 *Taxes* 421, 421–3, summarizing the facts in 92 contemplation of death cases that were litigated in the period 1939–44:

> Four tests are often mentioned as being important evidentially in determining whether a gift was in contemplation of death. These are (1) size of the transfer; (2) age of transferor at time of making the gift, (3) time interval between transfer and death; and (4) state of the transferor's health. This article examines the cases of the last five years with particular reference to these criteria. . . .
>
> The 92 cases examined involved 112 transfers alleged to have been made in contemplation of death. Of the total number of transfers, 34% were held upon final adjudication to be in contemplation of death. The Government's record of success in the Federal courts is somewhat better than its record before the Tax Court, since it won 46% of the 52 transfers tried in the Federal courts and only 23% of the 60 transfers tried before the Tax Court.
>
> All of the transfers litigated were of substantial size and averaged over $250,000. The data show no consistent relationship between the size of the transfer and the ratio of cases won by the Government. . . .
>
> The age of the transferor when making the alleged gift in contemplation of death offers little guide as to whether the court will find for the Government. . . .
>
> The Government is no more successful in suits involving gifts made shortly before death than where long periods have elapsed.* . . .
>
> The state of a transferor's health is obviously an important consideration and one often referred to in litigation. It is probably the single most definite objective criterion. Where a person knows he is seriously ill and is not on the road to recovery, a gift of substantial size made by him is likely to be found to be in contemplation of death. The area of doubt here, however, is due to the uncertainty as to whether the transferor knew of his physical state. If it is not shown that he did know, then the mist of indefiniteness again shrouds the question. . . .
>
> Further analysis of the cases seems unnecessary in order to demonstrate that the courts have made little progress during the last few years toward clarifying the law and setting objective standards for the determination of when a gift is in contemplation of death. The four so-called objective tests, upon analysis, lend little help insofar as definiteness is concerned.

2. In the *Johnson* case, the court states (*supra*, pp. 1051-2) that among the circumstances to be weighed in determining whether a gift is in contemplation of death are "the existence of a general testamentary scheme of which the transfers were a part" and "the existence of the desire by the decedent of avoiding estate taxes by means of making *inter vivos* transfers of property." Regs. 105, Sec. 81.16, provides:

> A transfer in contemplation of death is a disposition of property prompted by

* The transfers in question, of course, were not subject to the 3-year limitation enacted in 1950. *Supra*, p. 1041. [Ed.]

the thought of death (though it need not be solely so prompted). A transfer is prompted by the thought of death if it is made with the purpose of avoiding the tax, or as a substitute for a testamentary disposition of the property, or for any other motive associated with death.

In *Deniston* v. *Commissioner* 106 F.2d 925, 928 (3d Cir. 1939), however, the court said:

> We think that because in carrying out a plan to provide for her children the donor uses a method which she thinks is best calculated to save death taxes the conveyance is not thereby conclusively stamped as "in contemplation of death." The desire to avoid estate taxes may be just as clearly present in the mind of a young and vigorous donor who thinks of death as far distant as in that of one who is old and feeble and who looks momentarily for its coming. Standing alone it cannot be deemed conclusive of a mental state such as is contemplated by the statutory phrase "contemplation of death."

But the same court later affirmed, *per curiam*, a decision in which the district court had said:

> On these facts, we can draw no other conclusion than that the transfer was made with intention that these properties should not be liable for Federal estate tax. If that is so, naturally the transfer must have been made in contemplation of death. (*Commonwealth Trust Co.* v. *Driscoll*, 50 F.Supp. 949, 951, aff'd 137 F.2d 653 (3d Cir. 1943), cert den., 321 U.S. 764 (1944).)

In *Allen* v. *Trust Company of Georgia*, 326 U.S. 630 (1946), the Supreme Court affirmed a judgment in a case in which the district court had held that a release of a power to amend certain trusts was not in contemplation of death, even though the only reason for the release was to avoid the federal estate tax. The decedent had created two spendthrift trusts during his lifetime for the benefit of his children. Because they had suffered financial reverses and were heavily in debt, he intended to insulate the trust property against any tax or other claims that might arise He retained a power to amend the trusts with the consent of the trustee and beneficiaries, believing that the retention of such a power would not require the property to be included in his gross estate. In 1935, however, the Supreme Court held (*infra*, p. 1087) that the reservation of such a power did bring trust property into the gross estate; and in 1937, to avoid this result, the decedent released his power to amend the trusts. The government argued that the property must be included in the gross estate because the release was motivated solely by an intent to avoid the estate tax,* but the Supreme Court said.

> But that is to isolate the release from all that preceded and to treat it as a wholly independent transaction. This is not a case where a settlor, having made one plan for the disposition of his property, later makes a different one to avoid death taxes. Mr. Spalding, in making the release, did what he originally intended to do—to make complete and absolute gifts to his children, freed of all claims, including taxes. Retention of the power to amend would have brought the trust property into Mr. Spalding's estate and subjected it to the estate tax lien. His purpose to take care of his children, come what may, might thus have been thwarted or impaired. He guessed wrong on the law, when he retained the power to amend. When he rectified the error, he was in good faith, endeavoring to complete his original project, not to give his children more than he at first intended in order to save taxes. What he did in 1937 was merely to accomplish by an additional step what he assumed he had already done. . . . On these facts, his desire to avoid death taxes does no

* If property would be included in the gross estate because the decedent retained a power to amend the provisions of the trust, it must also be included if the decedent relinquished such a power in contemplation of death. §2038(a)(1) and (2).

more than establish that he did not want his plan to underwrite the necessities of his children and grandchildren jeopardized. His desire to make adequate provision for them remained the dominant motive, or so the triers of fact could properly find. (326 U.S. at 636–7.)

Note that the decedent's original purpose "to take care of his children, come what may" could have been jeopardized only if the estate tax could not have been paid out of the rest of his property. If the purpose of the *original* transfer had been to protect his children against estate tax and other claims, would the transfer itself (or the release, if a power to amend had been retained and later relinquished) be in contemplation of death?

3. Elsewhere in the *Trust Company of Georgia* case, the Supreme Court characterized as "a correct statement of the governing principle" the government's argument that "the statute is satisfied . . . where for any reason the decedent becomes concerned about what will happen to his property at his death and as a result takes action to control or in some manner affect its devolution." (326 U.S. at 635.)

Is it fatal to make a will at the same time as an *inter vivos* gift? In *Davidson's Estate* v. *Commissioner,* 158 F.2d 239 (10th Cir. 1946), the court was concerned with whether certain gifts in trust, made by a woman in good health at the same time that she executed a will, were made in contemplation of death. The court said:

Viewed in their entirety, it is not difficult to consider the will and the trust instruments as integrated parts of a single plan, testamentary in nature, for the disposition of decedent's estate to take effect at her death. . . . The will and the trust had the common objective of financial provision for the beneficiaries after decedent's death, and it is not unreasonable to conclude from all the facts and circumstances in the case that they both sprang from the same motive, namely, a disposition, in the nature of a testamentary disposition, of her estate. Nothing was accomplished by the trust instrument that could not have been done in the same way and to the same extent by the will. The conclusion by the Tax Court that the will and the trust represent a complete plan for the disposition of her estate upon death is not one which is without support in the facts. (158 F.2d at 243.)

See Cleary, "Protecting the Family Through Estate Planning," 25 *Taxes* 543, 551 (1947):

Decisions such as this [*Davidson's Estate* v. *Commissioner, supra*] indicate the danger of a holding that *inter-vivos* transfers are made in contemplation of death where an intelligent over-all plan, carefully worked out, involves both *inter-vivos* transfers and testamentary dispositions and correlates the two in any way.

The situation makes effective estate planning difficult. It is hardly possible for the parties to close their eyes to the estate tax consequences of *inter-vivos* gifts. It seems impracticable, if not blameworthy, to refrain from calling to the client's attention these highly important tax factors. Well-advised counsel cannot discuss estate planning problems without mentioning the possibility that transfers may be held to be made in contemplation of death. Suppression or concealment of computations, correspondence or advice, certainly is not a satisfactory solution.

Yet, as a practical matter, we know that people must plan. As the Supreme Court recognized in the *Trust Company of Georgia* case, one cannot fail to know that if he gives away property in his lifetime, he at least will not be the owner of that property at the time of his death. We also know that, by and large, the government has had rather hard going in the contemplation-of-death case, notwithstanding the language in the cases.

The objective of sound estate planning, therefore, must be to make *inter-vivos* transfers primarily for motives associated with life, and to keep such records of the decedent's motives that it can be proved that the dominant motive for the transfer was associated with life. Furthermore, in the correspondence and computations care should be taken to emphasize the income tax savings and the motives associated with life. The uncertainties as to the possible estate tax savings should be specifically pointed out—for example, the discount factor, the possible early death

of the donee, the possible depreciation in the value of the property during the donor's life, the possibility of reductions in rates, *etc.* There is, I think, a tendency to overstate and emphasize improperly the potential estate tax savings, a tendency which certainly should be avoided.

4. Another factor that may lead to the conclusion that a gift was made in contemplation of death is that no income will be produced by the transferred property before the transferor dies. See *Reeves' Estate* v. *Commissioner*, 180 F.2d 829 (2d Cir. 1950), involving a transfer of corporate stock on which no dividends were paid until the transferor's death, although the corporation's earnings were substantial: "From this fact, and from decedent's always powerful, if not always mathematically controlling interest in the corporation, the Commissioner inferred an intent not to pay dividends so long as decedent managed the affairs of the corporation." The Tax Court's holding that the gift was made in contemplation of death was affirmed, since "the record is bare of any explanation which makes the Commissioner's position seem unreasonable." The suggestion that a transfer of non-income-producing property is necessarily in contemplation of death, at least if the transferee is unable to sell the property and invest the proceeds in income-producing property, apparently derives from cases dealing with transfers of life insurance policies. *Infra* pp. 1169-70.

5. In *Farmers' Loan & Trust Co.* v. *Bowers*, 98 F.2d 794 (2d Cir. 1938), cert. denied 306 U.S. 648, the government showed that William Waldorf Astor made a transfer in England in 1919 that was motivated in part by a desire to avoid United States income and estate taxes and in part by a fear that England, where he lived, would enact a capital levy. Avoidance of the federal estate tax was a substantial motive for the transfer, but it may not have been the dominant motive, and the taxpayer argued that the trial judge committed error in charging the jury that if "the motive of avoiding the estate tax played a substantial part in causing Astor to make the transfers, the transfers must be held to have been made in contemplation of death." The Court of Appeals held that the charge was correct After quoting extensively from the *Wells* case, *supra*, p. 1041, the court said·

> While the Supreme Court may have intended to lay down the rule that even a substantial death motive would not bring a case within the statute if the dominant motive was to relieve the settlor of care, to give his children experience in managing their own affairs, to settle property upon them during his lifetime, or to carry out some other beneficent purpose, we do not think such a rule extends to a situation where a substantial motive to avoid estate taxes is accompanied by motives to escape other kinds of taxation. These remaining motives, though lawful, can hardly be regarded as reasons for engrafting exceptions upon a statute taxing transfers made in contemplation of death generally. These motives differ greatly from the beneficent purposes listed in the *Wells* Case and are neither included in the statute as grounds of exception, nor made such under any decision.

The *Astor* case was followed by an amendment to the Regulations, by which the definition of a gift in contemplation of death was given its present form. *Supra*, pp. 1055-6. Previously, the regulations had provided:

> If the transfer results from mixed motives, one of which is the thought of death, the more compelling motive controls. (Regs. 80, Art. 16.)

For criticism of the change, see Pavenstedt, "Taxation of Transfers in Contemplation of Death· A Proposal for Abolition," 54 *Yale L. J.* 70, 74–86 (1944).

6. The model estate tax statute drafted for the American Law Institute (Tentative Draft No. 9) proposes that the present statutory scheme be continued (with the period lengthened to 5 years) or, as an alternative, that all gifts within 3 years of death be subjected to estate tax. The latter proposal assumes that *Heiner* v. *Donnan*, *supra*, p. 1041 would either not be followed today or would be distinguished because the proposal does not use the language of presumption. See the *Bullard* case, *infra*, pp. 1107-8. Other remedies that have been recommended are the following.

(a) Pavenstedt, 'Taxation of Transfers in Contemplation of Death: A Proposal for Abolition,' 54 *Yale L.J.* 70, 91 (1944)

> The contemplation of death provision has been a vehicle primarily for the harassment of taxpayers and has yielded little revenue to the Government It is submitted that it should be repealed with retroactive effect except as to transfers made at a time when the gift tax was not in effect
>
> If Congress for any reason is unwilling to go that far, then it should re-enact a conclusive presumption, but should limit the 'contemplation of death" provision to the period covered by that presumption Such a presumption, if limited to the two-year period, might almost wholly obviate the difficulties which now beset taxpayers, as well as the Government's difficulties of valuation involved in following assets transferred many years ago. However, such a presumption, in order to approximate reality, should be limited to transfers made after a certain age and should include a standard more precise than the present statutory language which refers to "any transfer of a material part" of decedent's property.

(b) Paul, 1 *Federal Estate and Gift Taxation* (1942), p. 281:

> It is, therefore, suggested that a statute be enacted providing for a conclusive two-year presumption with respect to a decedent of a minimum specified age, let us say sixty-five years, who has made a transfer by trust or otherwise of a substantial part of his property in the nature of a final disposition to his heirs-at-law or other natural objects of his bounty Such a provision would involve three conditions (1) a minimum age, (2) a transfer of a substantial part of the decedent's property, and (3) a transfer to heirs or natural objects of the decedent's bounty

(c) Paul, as tax adviser to the Secretary of the Treasury, Hearings before House Ways and Means Committee, 77th Cong, 2d Sess., on Revenue Revision of 1942, p. 91

> The existing rebuttable presumption that a gift is in contemplation of death if made within 2 years of death has been productive of litigation but not of revenue It is therefore proposed that the provision be amended to provide that all transfers made by the donor over the age of 65, to the extent that such transfers to any one beneficiary exceed, in the aggregate, a specified sum, shall be subject to the estate tax

(d) Lowndes and Rutledge, "An Objective Test of Transfers in Contemplation of Death," 24 *Texas L. Rev.* 134, 158–159 (1945)

> The basic difficulty with the contemporary criterion of transfers in contemplation of death springs from the fact that it is premised in large part upon an unprovable fact, the secret motive of a dead man The solution is to substitute a test based upon a provable fact Whether or not a reasonable man in the position of the deceased donor when he made the gift would have realized that he had no substantial life expectancy

7 The proposed integrated transfer tax (*supra*, pp 901-2) would eliminate the contemplation of death issue (except as to transfers made before its enactment, which would become part of decedent's gross estate) Note that the transfer tax paid on gifts made within one year prior to, but not in the same calendar year as transferor's death would be added to the gross estate, restricting to that extent the advantage that lifetime transfers enjoy over testamentary transfers. A similar result is reached as to gifts in the calendar year of death by treating them as part of the gross estate and thus as testamentary transfers. *Supra*, p 902, note 30, at 134-6.

The "accessions tax" proposed by Rudick would also eliminate the contemplation of death issue *Supra*, p. 903.

8. Section 2035 provides that the gross estate "shall include the value of all property . . . to the extent of any interest therein of which the decedent has at any time made a transfer . . in contemplation of death " If cash is given in contemplation of death, it has been held that the full amount is taxable even though the donees no

longer have it when the donor dies. *Estate of Humphrey* v. *Commissioner*, 162 F.2d 1 (5th Cir. 1947), cert. denied, 332 U.S. 817 (1947). The reasoning of the court would apparently require inclusion of the value at death of donated property such as securities or real estate, even if that value exceeded the value of the property at the time of the gift·

> The evident purpose is to make the transferred property cause the same tax result as if the decedent had kept it till he died instead of transferring it. We do not accede to the argument that if the transferee injures or makes way with it, it shall be considered that he has acted as the agent of the decedent, or that he may substitute it by other property of less value. What is to be valued at the time of decedent's death is the very property which the decedent transferred. (162 F.2d at 2).

Similarly, in *Igleheart* v. *Commissioner*, 77 F.2d 704 (5th Cir. 1935), the court held that the value of the corpus of a trust at the date of death was includible in the gross estate, although this amount exceeded its value at the time of the gift: "For the purposes of the tax, property transferred by the decedent in contemplation of death is in the same category as it would have been if the transfer had not been made and the transferred property had continued to be owned by the decedent up to the time of his death." (77 F 2d at 711) See also *Burns* v. *Commissioner*, 177 F.2d 739 (5th Cir. 1949), affirming *Estate of Frizzell* v. *Commissioner*, 9 T.C. 979 (1947) (discussing the issue more fully); *Commissioner* v. *McDermott's Estate*, ____ F.2d ____ (7th Cir. 1955); *Commissioner* v. *Gidwitz*, 196 F.2d 813 (7th Cir. 1952); Pavenstedt, "Taxation of Transfers in Contemplation of Death: A Proposal for Abolition," 54 *Yale L. J.* 70, 87–90 (1944); 61 *Harv. L. Rev.* 365 (1948).

9. As noted *supra*, p. 968, for income tax purposes, inherited property takes as its basis in the hands of the heir its value as of the decedent's death. Before 1954, this rule was not applicable to gifts in contemplation of death, since the applicable provision, §113(a)(5) of the 1939 Code, was limited to property "acquired by bequest, devise, or inheritance." But §1014 of the 1954 Code greatly expands the categories of property whose basis shifts at death, and gifts in contemplation of death are subject to §1014(b)(9). If the donated property is sold *before* the donor's death, however, its income tax basis is prescribed by §1015; so that the donee's income tax may be substantially affected by his timing. If he sells shortly after the decedent's death, moreover, he may not know until months or years later whether his income tax basis should be determined under §1014(b)(9) or under §1015. If a transfer was not taxed to the estate as a gift in contemplation of death, may the donee (perhaps many years later) assert that it should have been included in the gross estate and that he is entitled to a stepped-up income tax basis for the property?

A conflict of interest between the estate and the donee may arise if the government asserts that a transfer was made in contemplation of death, since the estate tax burden on the estate may be less than the income tax savings that the donee would derive from a stepped-up basis. A similar conflict was noted *supra*, p. 968.

Section C. Revocable Transfers: Section 2038

Internal Revenue Code of 1954

Sec. 2038. Revocable Transfers.

(a) In General.—The value of the gross estate shall include the value of all property (except real property situated outside of the United States)—

(1) Transfers after June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to

when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

(2) Transfers on or before June 22, 1936—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

Note

From 1916 to 1924, the estate tax statute did not refer specifically to revocable trusts, but they were includible in the gross estate by virtue of a clause reaching any transfer by trust or otherwise "intended to take effect in possession or enjoyment at or after death." Moreover, it was held that revocable transfers made before 1916 could be reached, if the transferor died after 1916; the claim that to include such property in the gross estate was retroactive legislation in violation of the due process clause of the Fifth Amendment was rejected on the ground that the transfer was not complete until the transferor's death and that the tax was imposed on the shifting of economic benefits at death. *Reinecke* v. *Northern Trust Co*. 278 U S. 339 (1929).

In 1924, the prototype of what is now §2038 was enacted, reaching transfers where enjoyment was subject at the date of the decedent's death "to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death. . . ." This provision was changed from time to time after 1924, and took on its present form in 1936.* Some of the post-1924 changes, as will be seen, were declaratory rather than substantive.

1. Where Grantor's Power Is Unrestricted

PORTER v. COMMISSIONER

Supreme Court of the United States, 1933
288 U S 436

Mr. Justice Butler delivered the opinion of the Court

The question presented is whether, for the purpose of determining the tax liability of the estate of the deceased, § 302(d) of the Revenue Act of 1926 †

* What if the grantor's power to revoke was not expressly reserved in the trust instrument but rather arose by operation of law? In several states voluntary trusts are revocable by the settlor unless expressly made irrevocable in the trust instrument Calif Civil Code Sec. 2280, 60 Okl. St. Ann. Sec. 175 41, 20 Vernon's Rev. Civil St. of Tex. Art 7425b-41. In Louisiana, the Code of 1808 provided that interspousal gifts were always revocable, the provision was repealed in 1942. Louisiana Civil Code, Art. 1749 1. See *Vaccaro* v *United States*, 149 F 2d 1014 (5th Cir. 1945); 55 *Harv. L. Rev.* 684 (1942), Cappa, "The Effect of Section 2280 of the California Civil Code on the Federal Estate Tax Liability," 15 *So. Calif. L. Rev.* 155 (1942). Apart from statute, the grantor may have the power to revoke or rescind because of his incapacity, the beneficiary's fraud, *etc.*; see Scott, *The Law of Trusts*, Secs. 329A–333.

† The prototype of §2038, quoted *supra.* [Ed.]

requires that there shall be included in the value of the gross estate certain bonds that he had transferred in trust.

October 18, 1918, and again on February 1, 1919, decedent transferred to the Bankers Trust Company certain bonds for the benefit of his daughter and her son. Contemporaneously he made similar transfers of bonds to the same trustee for the benefit of his son and his son's daughter. November 27, 1926, in order to make provision for two children of his daughter born after the creation of these trusts, he sent the trust company letters purporting to revoke the trusts of which she was a beneficiary, to terminate the interest of all persons therein and to direct it to deliver the principal and income to itself as trustee according to a new deed then delivered. Each of the five trust agreements included provisions governing the management, investment, and disposition of principal and income, and contained a paragraph reserving to the donor power at any time to alter or modify the indenture and any or all of the trusts in any manner but expressly excepting any change in favor of himself or his estate.[1]

Deceased died November 30, 1926. The Commissioner of Internal Revenue included in the gross estate the value of the property described in the last deed and petitioners sought redetermination. The Board of Tax Appeals, because of the reserved power to alter and amend, held §302(d) applied, and included the corpus of all the trusts in the gross estate. 23 B T.A. 1016. The Circuit Court of Appeals affirmed that ruling. 60 F.(2d) 673. Its decision being in conflict with that of the Circuit Court of Appeals for the First Circuit in *Brady* v. *Ham*, 45 F.(2d) 454, and that of the Court of Appeals of the District of Columbia in *Cover* v. *Burnet*, 60 App D.C. 303; 53 F.(2d) 915, we granted a writ of certiorari 287 U.S. 591.

By the trust agreements, decedent divested himself of all interest in the bonds and, subject only to the reserved power, transferred full title to the trustee and beneficiaries. The reservation is broad, evidently he intended to be free at any time and from time to time to alter or modify the disposition of the property as he might see fit, subject to the restriction above mentioned. The power did not amount to an estate or interest in the property. It was much like, and for the

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[1] Paragraph tenth in each of the transfers is as follows:

"Notwithstanding anything to the contrary herein contained, the Donor at any time during the continuance of the trust herein provided for may, by instrument in writing executed and acknowledged or proved by him in the manner required for a deed of real estate (so as to enable such deed to be recorded in the State of New York) delivered to the trustee, or its successor, modify or alter in any manner this indenture, and any or all of the trusts then existing and the limitations and estates and interest in property hereby created and provided for subsequent to such trusts, and in case of such modification or alteration said instrument shall direct the revised disposition to be made of the trust fund or the income thereof, or that part of the trust fund or the income thereof affected by such modification or alteration, and upon the delivery of such instrument to the Trustee or its successor said instrument shall take effect according to its provisions, and the Trustee or its successors shall make and execute all such instruments, if any, and make such conveyance, transfers or deliveries of property as may be necessary or proper in order to carry the same into effect, and no one, born or unborn, shall have any right, interest, or estate under this indenture except subject to the proper modification or alteration thereof, but this power to modify or alter is not intended and shall not be construed to include the right to the Donor to make such modification or alteration in his own favor or in favor of his estate, but shall apply only so far as the interest of third parties may be concerned."

purposes of this case may be deemed the substantial equivalent of, a general power of appointment by will. . . .

The Act, §301(a), imposes a tax "upon the transfer of the net estate of every decedent." The net estate as there used does not mean an amount to be ascertained as such under any general rule of law or under statutes governing the administration of estates, but is the gross estate as specifically defined in §302 less deductions permitted by §303. The former section declares that "the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—(a) To the extent of the interest therein of the decedent at the time of his death."

(b) To the extent of any interest therein of the surviving spouse as or in lieu of dower or curtesy. (c) To the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise in contemplation of or intended to take effect in possession or enjoyment at or after his death.

(d) "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke. . . ."

(e) To the extent of the interest therein held by decedent as a joint tenant or as a tenant by the entirety. (f) To the extent of any property passing under a general power of appointment exercised by the decedent by will or by deed in contemplation of or intended to take effect in possession or enjoyment at or after death. (g) To the extent of the amount of life insurance receivable as specified. Subdivision (h) requires the interests defined in (b) to (g) inclusive to be included whether transfer was made before or after the passage of the Act.

Petitioners contend that the only thing taxed is the transfer of the net estate at death, and that property in which the decedent then held no interest or power of enjoyment must be excluded. They rely on *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339. But that case is not in point. It involved seven trusts created by the decedent. Two were held taxable because subject to a power of revocation in him alone. In each of the others he reserved power to alter, change or modify, to be exercised in four by joint action of himself and a single beneficiary and in the remaining one by himself and a majority of the beneficiaries acting jointly. As the title was put beyond his control, we held these transfers not taxable. And petitioners assume, as held in *White* v. *Erskine*, 47 F.(2d) 1014, that (a) is a limitation upon (d) and argue that the gross estate includes property only to the extent of the "interest therein of the decedent at the time of his death" and that, as before his death he had divested himself of all title, the property so transferred is not to be included in the gross estate. But the construction thus taken for granted cannot be sustained. Subdivision (a) does not in any way refer to or purport to modify (d) and, in view of the familiar rule that tax laws are to be construed liberally in favor of taxpayers, it cannot be said that, if it stood alone, (a) would extend to the transfers brought into the gross estate by (d). *United States* v. *Field*, 255 U.S. 257, 264. Moreover, Congress has progressively expanded the bases for such taxation. Comparison of §302 with corresponding provisions of

earlier Acts warrants the conclusion that (d) is not a mere specification of something covered by (a) but that it covers something not included therein. . . .

The net estate upon the transfer of which the tax is imposed, is not limited to property that passes from decedent at death. Subdivision (d) requires to be included in the calculation all property previously transferred by decedent, the enjoyment of which remains at the time of his death subject to any change by the exertion of a power by himself alone or in conjunction with another. Petitioner argues that, as decedent was without power to revoke the transfers or to alter or modify the trusts in favor of himself or his estate, the property is not covered by subdivision (d). But the disjunctive use of the words "alter," "modify" and "amend" negatives that contention. We find nothing in the context or in the policy evidenced by this and prior estate tax laws or in the legislative history of subdivision (d) to suggest that conjunctive use of these words was intended, or that "alter" and "modify" were used as equivalents of "revoke" or are to be understood in other than their usual meanings. We need not consider whether every change, however slight or trivial, would be within the meaning of the clause. Here the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect of the creation of the trusts even to the extent of taking the property from the trustees and beneficiaries named and transferring it absolutely or in trust for the benefit of others. So far as concerns the tax here involved, there is no difference in principle between a transfer subject to such changes and one that is revocable. The transfers under consideration are undoubtedly covered by subdivision (d).

Petitioners contend that so construed §302(d) is repugnant to the due process clause of the Fifth Amendment. They insist, and we assume, that the measures taken by means of decedent's letter to the trustee and the new deed of November 27, 1926, operated merely to alter and modify but did not supersede the earlier trusts made for the benefit of his daughter and her son. They maintain that inclusion of the transfers in question would be to measure decedent's tax by property belonging to others, a thing condemned in *Heiner* v. *Donnan*, 285 U.S. 312, and *Hoeper* v. *Tax Commission*, 284 U.S. 206, and would be to tax gifts *inter vivos* that were fully consummated prior to the enactment of subdivision (d) and therefore would be confiscatory under *Nichols* v. *Coolidge*, 274 U.S. 531, and *Heiner* v. *Donnan*, *supra.*

They treat as without significance the power the donor reserved unto himself alone and ground all their arguments upon the fact that deceased, prior to such enactment, completely divested himself of title without power of revocation. It is true that the power reserved was not absolute as in the transfer considered in *Burnet* v. *Guggenheim*, *supra*, in which this court, in the absence of any provision corresponding to subdivision (d), held that the donor's termination of the power amounted to a transfer by gift within the meaning of §319 of the Revenue Act of 1924, 43 Stat. 313. But the reservation here may not be ignored, for, while subject to the specified limitation, it made the settlor dominant in respect of other dispositions of both corpus and income. His death terminated that control, ended the possibility of any change by him, and was, in respect of title to the property in question, the source of valuable assurance passing from the dead to the living. That is the event on which Congress based the inclusion of property so transferred

in the gross estate as a step in the calculation to ascertain the amount of what in §301 is called the net estate. Thus was reached what it reasonably might deem a substitute for testamentary disposition *United States* v. *Wells,* 283 U.S. 102, 116. There is no doubt as to the power of Congress so to do. . . .

Judgment affirmed.

Mr. Justice Cardozo concurs in the result.

COMMISSIONER v. CHASE NATIONAL BANK

U.S. Court of Appeals, Second Circuit, 1936
82 F.2d 157, cert. den., 299 U.S. 552

Before L. Hand, Swan, and Chase, Circuit Judges.

Chase, Circuit Judge.

The respondent is the ancillary administrator of the estate of Vivien Helen De La Poer Beresford, a resident of England, who died intestate on February 3, 1931, leaving three surviving children.

On December 14, 1920, the decedent created an irrevocable trust, of which the respondent is the successor trustee, covering her entire interest in the estate of her grandfather. The trust deed provided that after a loan made to her husband by her father had been paid, the decedent should receive the income during her life and thereafter the corpus, together with any undistributed income then remaining, should be paid to her lawful descendants in such proportions as she should in her last will appoint. It was also provided that if she made no appointment the trust property should be distributed among such descendants in equal shares per stirpes with alternative provisions for distribution in the event that she should die leaving no such descendants.

The Commissioner's action in including the value of the corpus of the trust in the gross estate of the decedent was reviewed by the Board of Tax Appeals. A majority of the Board having decided adversely to the Commissioner on this point, he has brought this petition for review.

The petitioner relies in support of his action upon subdivisions (c) and (d) of section 302 of the Revenue Act of 1926. They follow:

> Sec. 302. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . .
>
> (c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth. . . .
>
> (d) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth.

We think subdivision (d) authority for the inclusion of the trust corpus in the decedent's gross estate. Up to the time she died she had the power to alter the

proportions in which her descendants should take the property in accordance with the original terms of the trust instrument. She could have limited any, or all but one, of them to a nominal amount and given all of real value to one or to such of them as she pleased. Her death eliminated the possibility of any such change in the provisions of the deed of trust and made it certain that her lawful descendants would take the property in equal shares per stirpes. The power she reserved was not to change the trust provisions in a trivial way, but went right to the heart of them and gave the decedent a substantial though qualified control over the trust property until her death. Such a power to alter or amend the substance of the transfer by trust brought it within the scope of the decision in *Porter* v. *Commissioner,* 288 U S. 436, and justified the inclusion of the property in the gross estate of the decedent. . . . The decedent, having the right to change the economic benefit, had the power to alter within section 302(d) of the 1926 Act even though she could not benefit herself in a pecuniary way by the change. *Witherbee* v. *Commissioner* (C.C.A.) 70 F.(2d) 696. She lived several years after the act took effect and she was on notice of its provisions, retaining the reserved powers when she might have given them up to rid her estate of this tax liability. So there has been no denial of rights under the Fifth Amendment. . . .

Reversed.

COMMISSIONER v. ESTATE OF HOLMES

Supreme Court of the United States, 1946
326 U.S. 480

MR. JUSTICE RUTLEDGE delivered the opinion of the Court

In *White* v. *Poor,* 296 U.S. 98, the question arose whether the power "to alter, amend, or revoke" included the power of a decedent to terminate a trust so as to bring the trust estate within his gross estate for purposes of the transfer tax imposed by §302(d) of the Revenue Act of 1926 The Court, finding it unnecessary to determine that question, disposed of the case upon another ground. The question is here again, this time inescapably, but with a further legislative history and a somewhat different setting of fact.

In 1936, immediately following the *White* decision, Congress revised §302(d) by rewriting it into two separate paragraphs relating to "revocable transfers," one applying to transfers after June 22, 1936, the other to transfers on or prior to that date. These are now §§811(d)(1) and (2) of the [1939] Internal Revenue Code [§§2038(a)(1) and (2), 1954 Code]. For present purposes the difference claimed to be important consisted in changing the phrase "to alter, amend, or revoke" applying to transfers on or prior to June 22, 1936, so that in §811(d)(1) it reads "to alter, amend, revoke, or terminate," as to transfers after that date

However §811(d)(2) governs the transfer in this case, since it was made in January, 1935, prior to the dividing date. And the question most mooted has been whether the change was one of substance or was only a clarifying amendment. Put differently, the principal issue is whether power to "alter, amend, or revoke" included power merely to terminate the interests created by the trust or required some further change. . . .

The facts were stipulated. In so far as necessary to state, they are as follows. On January 20, 1935, by a single trust indenture Holmes created three several irrevocable trusts, one for each of three sons then aged 22, 19 and 14 years respectively. Each was given the beneficial interest in one-third of a common fund consisting of corporate stock later converted into other assets The three trusts were identical in terms Holmes was named and acted as trustee until his death October 5, 1940.

Each trust was to continue for a period of fifteen years, unless earlier terminated under power reserved to the grantor, or for a longer term on specified conditions summarized below. But the grantor reserved to himself during his lifetime the power to terminate any or all of the trusts and distribute the principal, with accumulated income, to the beneficiaries then entitled to receive it.[1] He retained no power to revest in himself or his estate any portion of the corpus or income.

Various provisions for disposition over were made to cover contingencies created by the death of beneficiaries during continuance of the trust. Generally stated, the scheme was that the surviving issue of each son should take his share of the corpus, receiving it share and share alike, unconditionally if over 21; as beneficiaries until attaining that age, if under it If a son should die without issue, his "share or trust" was to go "pro rata" to the other two sons, or their surviving issue *per stirpes;* if either other son should be dead without issue, the survivor or his issue was to take the whole, and if all the sons should be deceased without issue, whatever might remain in the trust estate was given to the grantor's wife, if living, if not, to her heirs at law. The trust was to terminate in any event upon the death of the last survivor of the three sons and the expiration of twenty-one years thereafter

The trustee was given broad discretionary power to apply each beneficiary's share of the corpus for his maintenance, welfare, comfort or happiness, with a precatory suggestion of liberality

The income was subject to spendthrift provisions and discretionary power of accumulation. If not accumulated, it was to be distributed to the beneficiary, preferably in monthly instalments.

The principal contention is that the sum of the various provisions was to create or reserve to the decedent only a power to accelerate in time the enjoyment of the beneficial interests brought into being by the trusts, that these were vested interests, that no power was reserved to revest them or any of them in the donor or his estate or to change or alter them, or the terms of the gifts, in any manner other than by mere acceleration of enjoyment, and that the powers thus reserved

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[1] The power of termination was reserved by paragraph eleven of the indenture, as follows

"Grantor, during his lifetime, and my son or sons herein named, while acting as Trustee hereunder, may, if deemed advisable by them as Trustee, distribute to either of Grantor's children, the whole or any part of the principal of their respective trusts, and their interests thereunder And Grantor may, during his lifetime, if deemed advisable by him and my son or sons herein named, while acting as Trustee hereunder, may, if deemed advisable by them as Trustee, terminate either or all of said trusts herein created for the respective benefit of my said sons, and distribute the principal of the trust to the persons entitled to receive the same under the terms hereof on the date of such termination."

are not sufficient to bring the trust estate, or any part of it, within the coverage of §811(d)(2).[2]

This view presupposes two things. One is that termination of contingencies upon which enjoyment is dependent does not "change, alter, or revoke" enjoyment; the other, that the power "to alter, amend, or revoke" specified in §811(d)(2) does not include a power to terminate contingencies which accelerate enjoyment, with the effect of making certain that the beneficiary taking will have it rather than others to whom it would or might inure if termination were longer deferred.

One difficulty with respondent's position is in its conception of "enjoyment." More than once recently we have emphasized that "enjoyment" and "enjoy," as used in these and similar statutes, are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates. *Cf. United States* v. *Pelzer,* 312 U.S. 399, 403; *Fondren* v. *Commissioner,* 324 U.S. 18, 20, *Commissioner* v. *Disston,* 325 U.S. 442.[3] In this sense it is clear that none of the sons here had a present right to immediate enjoyment of either income or principal, see *Commissioner* v. *Disston, supra,* although each may have been invested with what respondent regards as a "fee simple" in an equitable interest, subject to divestment by the contingency of the beneficiary's death during continuance of the trust. So long as it continued—and it might continue for the life of the survivor of the three sons and 21 years—it could not be said with assurance that any of the sons, or his issue, would come into present enjoyment of his share, or any part of it; for in connection with the possible occurrence of many contingencies, including the grantor's death and his earlier exercise of the power of termination, it is to be recalled that the grantor reserved to himself, while acting as trustee, the power to accumulate the income.

It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if the power is not exercised, has power which affects not only the time of enjoyment but also the person or persons who may enjoy the donation. More therefore is involved than mere acceleration of the time of enjoyment. The very right of enjoyment is affected, the difference dependent upon the grantor's power being between present substantial benefit and the mere prospect or possibility, even the probability, that one may have it at some uncertain future time or perhaps not at all. A donor who keeps so strong a hold over the actual and immediate enjoyment of what he put beyond his own power to retake has not divested himself of that degree of control which §811(d)(2) requires in order to avoid the tax.

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[2] The taxpayer asserts that each son acquired, on execution of the indenture, "a fee simple title to one-third of the trust corpus and income," subject only to the trustee's power of management for 15 years at the most and to the son's living until this power should end. The reserved power of termination, it is said, applies only to the several contingencies which might affect the time of enjoyment, but not enjoyment itself.

[3] It is true that this case is not one involving the taxability of gifts of "future interests in property" as was true of the cases cited. It is likewise true that the laws relating to estate taxes and those relating to gift taxes are not completely reciprocal. *Estate of Sanford* v. *Commissioner,* 308 U.S. 39, *Smith* v. *Shaughnessy,* 318 U.S. 176. But there can be no difference in the meaning of the words "enjoyment" and "enjoy" as they are used in the pertinent statutory provisions respectively.

[The Court went on to hold that the addition in 1936 of the term "to terminate" was intended by Congress to be declaratory, rather than to change existing law.

[The taxpayer also argued that the power to terminate was reserved by the grantor as donor, rather than as trustee; and that the addition in 1936 of the term "in whatever capacity exercisable" was intended to change pre-1936 law. The Court said of this contention:]

If the question has been saved, we cannot say upon this language that the grantor did not reserve the power of termination to himself as donor rather than merely as trustee. It is unnecessary therefore to determine whether, if the reservation were different, the variation in wording between §§811(d)(1) and (2) in this respect would be material. We have considered respondent's remaining contentions and find them without merit.

The judgment of the Court of Appeals is reversed and the cause is remanded for further proceedings consistent with this opinion.

Reversed and remanded.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

Note

1. The Supreme Court (Justices Douglas and Jackson dissenting) went one step further in *Lober* v. *United States*, 346 U.S. 335 (1953):

> Petitioners stress a factual difference between this and the *Holmes* case. The Holmes trust instrument provided that if a beneficiary died before expiration of the trust his children succeeded to his interest, but if he died without children, his interest would pass to his brothers or their children. Thus the trustee had power to eliminate a contingency that might have prevented passage of a beneficiary's interest to his heirs. Here we assume that upon death of the Lober beneficiaries their part in the trust estate would, under New York law, pass to their heirs. But we cannot agree that this difference should change the *Holmes* result.
>
> We pointed out in the *Holmes* case that §811(d)(2) was more concerned with "present economic benefit" than with "technical vesting of title or estates." And the Lober beneficiaries, like the Holmes beneficiaries, were granted no "present right to immediate enjoyment of either income or principal." The trust instrument here gave none of Lober's children full "enjoyment" of the trust property, whether it "vested" in them or not. To get this full enjoyment they had to wait until they reached the age of twenty-five unless their father sooner gave them the money and stocks by terminating the trust under the power of change he kept to the very date of his death. This father could have given property to his children without reserving in himself any power to change the terms as to the date his gift would be wholly effective, but he did not. What we said in the *Holmes* case fits this situation too: "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which §811(d)(2) requires in order to avoid the tax." *Commissioner of Internal Revenue* v. *Holmes*, *supra*, 326 U.S. at page 487.

2. Note that while §2038 requires trust property to be included in the gross estate if the grantor retained any—or virtually any—power to "alter, amend, revoke, or terminate," §674 imposes income tax liability on him only if his power to control the beneficiaries' beneficial enjoyment is significant. *Supra*, p. 322. Many of the powers that, by virtue of §674(b), may be held by the grantor without income tax liability are sufficient to generate liability for estate tax.

3. There are three differences between §2038(a)(1) and §2038(a)(2) [§§811(d)(1) and (2) of the 1939 Code], all apparently prompted by *White* v. *Poor*, discussed in the *Holmes* case:

(a) The addition of the term "terminate," held to be declaratory in the *Holmes* case.

(b) The addition of the phrase "(in whatever capacity exercisable)," held declaratory in *Welch* v. *Terhune*, 126 F.2d 695 (1st Cir. 1942), cert. den., 317 U.S. 644, *Union Trust Co.* v. *Driscoll*, 138 F.2d 152 (3d Cir. 1943), cert. den., 321 U.S. 764 (1944), and *Commissioner* v. *Estate of Newbold*, 158 F.2d 694 (2d Cir. 1946). Note that the correctness of these decisions was not passed on in the *Holmes* case; see also *Jennings* v. *Smith*, *infra*, p. 1080.

(c) The addition of the phrase "(without regard to when or from what source the decedent acquired such power)." While even this phrase apparently is, at least in part, declaratory of the existing law (see *Vaccaro* v. *United States*, 149 F.2d 1014 (5th Cir. 1945); Regs. 105, Sec. 81.20), in other respects it marks a change of substance, prospectively overruling *White* v. *Poor, supra. Cutcheon* v. *Commissioner*, 3 T.C. 636 (1944).

COMMISSIONER v. HAGER'S ESTATE

U.S. Court of Appeals, Third Circuit, 1949
173 F.2d 613

Before GOODRICH, MCLAUGHLIN and KALODNER, Circuit Judges.

GOODRICH, Circuit Judge.

This case involves the liability of the estate of William M. Hager for asserted estate taxes under §811(d)(2) [§2038(a)(2), 1954 Code]. The Tax Court decided in favor of the taxpayer and the Commissioner's appeal has asked reversal. This we are going to grant. We held the case after submission because it was indicated to us that the decision of the pending case of *Commissioner* v. *Estate of Church*, 335 U.S. 632, would determine this one. It did not, but its bearing will be noted in the course of the discussion.

The question which we must decide is whether under the provisions of the trusts presently to be described the enjoyment was subject to change at the date of the grantor's death "through the exercise of a power . . . to alter, amend or revoke. . . ." If it was, the Tax Court was wrong and the Commissioner is entitled to the tax claimed.

The five trusts in question were set up in 1924. The decedent and his wife each contributed one half of the original corpus in certain shares of corporate stock. The children and grandchildren named as beneficiaries were given life estates together with powers to appoint the remainders by will. There were gifts over in default of appointment. The trusts were irrevocable and the trustee retained no power to terminate them prior to the designated period for their expiration, which was the death of the grantor's son.

The decedent was named trustee under all the trusts, and they were administered as a unit. He retained very wide powers, it quite evidently being the intention to set up the type of trust in which he hoped by the exercise of business judgment to enlarge the trust estate for members of his family. In particular, he was authorized, by paragraph 5 of each trust indenture, to determine, as it pleased him, whether gains realized from the sale of securities in the trusts should be

treated as income or retained as part of the corpus.[1] By paragraph 8 he could pay out or accumulate income at his sole discretion, and could treat the accumulations as corpus or income.[2] The Commissioner relies upon these paragraphs to show that the decedent, when he died, had in his hands the power to alter or amend.

The corpus of the estate increased in value and at the time of the decedent's death was considerably greater in dollar value than it was on the date created. The Commissioner, by stipulation, is claiming only half of the total value of the trusts. In other words, he is not claiming estate tax on the portion contributed to the trusts by Mrs. Hager, the decedent's wife, and the increment on that portion.

Except in one particular, *Commissioner* v. *Holmes' Estate*, 1945, 326 U.S. 480, is precisely in point. The difference between that case and this one is that in the *Holmes* trust the settlor had the power to terminate the trust before the date stipulated for expiration. The court's problem was to determine whether the power to "terminate" was a power to "alter or amend." It was held to be so in language which we think is pretty strongly persuasive in our situation here. The court said

> It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if the power is not exercised, has power which affects not only the time of enjoyment but also the person or persons who may enjoy the donation.

In this case our question is whether the power which the settlor retained is enough to be called the power to "alter or amend." He could allocate gains to income, so the life tenants would get them, or to corpus, so that the remaindermen would get them This we think is a very substantial power So, too, is the power to determine whether or not the life tenants are to get anything at all. It is, of course, well settled that the power to alter or amend does not have to extend to everybody in the world. It is sufficient if the power to allocate exists as among those named as beneficiaries or possible beneficiaries of a trust.[3] We think there

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[1] "(5) As between the beneficiary of this trust and those entitled to the remainder hereunder, any increment, however accruing, to the value of any investment constituting a part of the principal of the trust shall be for the benefit of those entitled to the remainder except that if any such security, to the value of which there shall be any increment, by way of increase of market price or otherwise, shall be sold or otherwise disposed of during the period of the trust, such increment, in the discretion of the Trustee, may be either treated as income to be disposed of in accordance with the terms hereof, or be retained as a part of the corpus of the trust '

[2] "(8) The Trustee may from time to time pay over to our said son, or expend for his benefit so much of the income from the trust estate as in the sole judgment of the Trustee it shall be advisable so to do So much of such income as shall not be so paid or expended shall be accumulated as a part of the trust estate, but at any time and from time to time after there has been any such accumulation of income, the Trustee may either pay the whole or any part thereof to our said son or expend it for his benefit—it being the intent that the income from the trust estate not actually paid over to or expended for the benefit of our said son shall not become irrevocably a part of the corpus of such estate, but may thereafter at any time and from time to time, be by the Trustee either paid over to him or expended for his benefit "

[3] See authorities collected in *Industrial Trust Co.* v. *Commissioner,* 1 Cir., 1947, 165 F.2d 142 [*infra*, p 1118].

is no doubt, therefore, that as to the increase in value of the trusts at the date of the settlor's death, he had the power to alter or amend as to (1) the increments to corpus which had come by the profitable buying and selling of securities, and (2) income of the life tenant which the settlor-trustee could withhold or pay over at his discretion.

Is the taxable interest limited to that just stated or does it include the one half the value of the total estates, as the Commissioner claims? This question the court did not have in the *Holmes* case. There the power to alter or amend by terminating the trust certainly cut across the entire corpus. That is not quite this case. Here the trustee, as explained above, could withhold income from a life tenant, reassign it to corpus and then assign it out again. He could allocate profits from buying and selling trust securities to either corpus or income. He could buy speculative securities if he chose. He was expressly empowered to exercise in dealing with the trust estates "each and every right that might be exercised by one holding the same as his individual property." But we take it that in spite of this clause he could not wilfully eliminate the interests of the remaindermen.

Our legal question, therefore, is whether such a limitation on the power of a grantor has the effect of limiting the power of the United States to levy its estate tax based on the value of the whole trust. The First Circuit has assumed so in a recent dictum. *Industrial Trust Company* v. *Commissioner*, 1 Cir., 1947, 165 F. 2d 142, 146. In *Commissioner* v. *Bridgeport City Trust Co.*, 2 Cir. 1941, 124 F.2d 48, the court upheld a claim by the Commissioner to the inclusion of the income beneficiaries' interest in a trust where a settler had reserved to himself the power to reallocate the disposition of the income. It is to be noted, however, that the Commissioner got, by this holding, all that he had claimed. Therefore, the question whether the value of the entire estate could have been subject to the estate tax was not before the court. And in *Helvering* v. *Proctor*, 2 Cir., 1944, 140 F.2d 87, the Second Circuit held that where the settlor had reserved an estate for life with remainders over, the principal was not includible in the gross estate for estate tax purposes. The discussion by the court, of course, turned around *May* v. *Heiner*, 1930, 281 U.S. 238, and its children and collateral relatives. Since *May* v. *Heiner* has now disappeared through the decisions of the Supreme Court in *Commissioner* v. *Estate of Church*, 335 U.S. 632, and *Estate of Spiegel* v. *Commissioner*, 335 U.S. 701, any structure based upon *May* v. *Heiner* has, obviously, lost its foundation. Our conclusion is that the grantor of these trusts retained to himself as trustee a sufficient power to alter or amend to affect very substantially the interests of the life tenants and the remaindermen, even though he could not, unless he lost all the money of the trusts by unfortunate investments, completely eliminate the remaindermen. He could certainly affect them by many of the things he kept power in himself to do. We think there is enough retained to bring the grantor within the wording of the statute and that the Commissioner's contention, therefore, must be upheld.

The decision of the Tax Court will be reversed and the case remanded for further proceedings not inconsistent with this opinion.

Note

1. Was the decision based on the grantor's power to allocate capital gains between

the life tenants and the remaindermen? If so, why was the entire corpus, rather than just the amount of such gains, included?

Was it the grantor's power to make investments that brought the corpus into the gross estate? (The investment clause is not set out in the Tax Court opinion, ¶46,266 P-H Memo TC). It has usually been assumed that investment powers, at least if they are of a "normal" character, do not bring a trust into the gross estate. *Reinecke* v. *Northern Trust Co*, 278 U.S 339, 346-7 (1929), is the original of this assumption, but this case was decided under the general language of the postponed-possession-or-enjoyment clause, rather than under the more specific language of §2038. See *Commonwealth Trust Co.* v. *Driscoll*, 50 F.Supp. 649 aff'd 137 F 2d 653 (3d Cir. 1943), cert. denied, 321 U.S. 764, involving an investment clause that was interpreted to mean that the grantor could withdraw any securities from the trust and substitute worthless ones in their place, the court found the clause, as thus construed, to be tantamount to a power to revoke. In *Estate of Downe* v. *Commissioner*, 2 T.C 967 (1943), the government sought to tax trust property under §2038 because the grantor retained "the option to direct in writing the Trustee to issue voting proxies on and to retain, sell, exchange, invest and reinvest any of the trust property held hereunder in such manner as he may direct and without liability to the Trustee for resulting loss" The court held that this option did not constitute a power to alter, amend, or revoke, citing cases holding that similar powers did not render the grantor liable for income tax on the trust income under §676 (taxing trust income to the grantor if he has a power to revest title to the corpus in himself). The court said "The two sections have a cognate purpose." 2 T.C at 973. But §676 is applicable only if the grantor can revoke, and an investment clause can hardly be interpreted as a power to revest unless it permits the grantor to buy back the corpus for a nominal consideration or otherwise to benefit himself. §2038, however, speaks of a power to alter, amend, or revoke. Should investment powers that are beyond the reach of §676 necessarily escape §2038? Is a power to favor the life tenant over the remainderman by investing in speculative securities with a high current yield within §2038? What of a power to favor the remainderman by investing in presently unproductive property with a prospect for appreciation over the long haul?

See again *supra*, pp. 976-7, on the relation of the *Clifford* case to the estate tax.

2. The final point—the quantum to be included in the gross estate—will be considered again, *infra*, pp. 1118–29.

GIFT TAX

ESTATE OF SANFORD v. COMMISSIONER

Supreme Court of the United States, 1939
308 U.S 39

MR. JUSTICE STONE delivered the opinion of the Court.

This and its companion case, *Rasquin* v. *Humphreys*, post, p. 54, present the single question of statutory construction whether in the case of an *inter vivos* transfer of property in trust, by a donor reserving to himself the power to designate new beneficiaries other than himself, the gift becomes complete and subject to the gift tax imposed by the federal revenue laws at the time of the relinquishment of the power. Correlative questions, important only if a negative answer is given to the first one, are whether the gift becomes complete and taxable when the trust is created or, in the case where the donor has reserved a power

of revocation for his own benefit and has relinquished it before relinquishing the power to change beneficiaries, whether the gift first becomes complete and taxable at the time of relinquishing the power of revocation.

In 1913, before the enactment of the first gift tax statute of 1924, decedent created a trust of personal property for the benefit of named beneficiaries, reserving to himself the power to terminate the trust in whole or in part, or to modify it. In 1919 he surrendered the power to revoke the trust by an appropriate writing in which he reserved "the right to modify any or all of the trusts" but provided that this right "shall in no way be deemed or construed to include any right or privilege" in the donor "to withdraw principal or income from any trust." In August, 1924, after the effective date of the gift tax statute, decedent renounced his remaining power to modify the trust. After his death in 1928, the Commissioner following the decision in *Hesslein* v. *Hoey*, 91 F.2d 954, in 1937, ruled that the gift became complete and taxable only upon decedent's final renunciation of his power to modify the trusts and gave notice of a tax deficiency accordingly.

The order of the Board of Tax Appeals sustaining the tax was affirmed by the Court of Appeals for the Third Circuit, 103 F.2d 81, which followed the decision of the Court of Appeals for the Second Circuit in *Hesslein* v. *Hoey*, *supra*, in which we had denied certiorari, 302 U.S. 756. In the *Hesslein* case, as in the *Humphreys* case now before us, a gift in trust with the reservation of a power in the donor to alter the disposition of the property in any way not beneficial to himself, was held to be incomplete and not subject to the gift tax under the 1932 Act so long as the donor retained that power.

We granted certiorari in this case, 307 U.S. 618, and in the *Humphreys* case, *id.* 619, upon the representation of the Government that it has taken inconsistent positions with respect to the question involved in the two cases and that because of this fact and of the doubt of the correctness of the decision in the *Hesslein* case decision of the question by this Court is desirable in order to remove the resultant confusion in the administration of the revenue laws.

It has continued to take these inconsistent positions here, stating that it is unable to determine which construction of the statute will be most advantageous to the Government in point of revenue collected. It argues in this case that the gift did not become complete and taxable until surrender by the donor of his reserved power to designate new beneficiaries of the trusts. In the *Humphreys* case it argues that the gift upon trust with power reserved to the donor, not afterward relinquished, to change the beneficiaries was complete and taxable when the trust was created. It concedes by its brief that " a decision favorable to the government in either case will necessarily preclude a favorable decision in the other."

In ascertaining the correct construction of the statutes taxing gifts, it is necessary to read them in the light of the closely related provisions of the revenue laws taxing transfers at death, as they have been interpreted by our decisions. Section 319 *et seq.* of the Revenue Act of 1924, 43 Stat. 253, reenacted as §501 *et seq.* of the 1932 Act, 47 Stat. 169, imposed a graduated tax upon gifts. It supplemented that laid on transfers at death, which had long been a feature of the revenue laws. When the gift tax was enacted Congress was aware that the essence of a transfer is the passage of control over the economic benefits of property

rather than any technical changes in its title. See *Burnet* v. *Guggenheim*, 288 U.S 280, 287. Following the enactment of the gift tax statute this Court in *Reinecke* v *Northern Trust Co.*, 278 U S. 339 (1929), held that the relinquishment at death of a power of revocation of a trust for the benefit of its donor was a taxable transfer, *cf. Saltonstall* v. *Saltonstall*, 276 U.S. 260; *Chase Nat'l Bank* v. *United States*, 278 U.S. 327; and similarly in *Porter* v. *Commissioner*, 288 U S. 436 (1933), that the relinquishment by a donor at death of a reserved power to modify the trust except in his own favor is likewise a transfer of the property which could constitutionally be taxed under the provisions of §302(d) of the 1926 Revenue Act (reenacting in substance 302(d) of the 1924 Act) although enacted after the creation of the trust. *Cf. Bullen* v. *Wisconsin*, 240 U.S 625, *Curry* v. *McCanless*, 307 U.S. 357; *Graves* v. *Elliott*, 307 U.S. 383. Since it was the relinquishment of the power which was taxed as a transfer and not the transfer in trust, the statute was not retroactively applied. *Cf. Nichols* v. *Coolidge*, 274 U.S. 531; *Helvering* v. *Helmholz*, 296 U.S. 93, 98.

The rationale of decision in both cases is that "taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed" (see *Corliss* v. *Bowers*, 281 U.S. 376, 378, *Saltonstall* v *Saltonstall*, *supra*, 261; *Burnet* v. *Guggenheim*, *supra*, 287) and that a retention of control over the disposition of the trust property, whether for the benefit of the donor or others, renders the gift incomplete until the power is relinquished whether in life or at death. The rule was thus established, and has ever since been consistently followed by the Court, that a transfer of property upon trust, with power reserved to the donor either to revoke it and recapture the trust property or to modify its terms so as to designate new beneficiaries other than himself is incomplete. and becomes complete so as to subject the transfer to death taxes only on relinquishment of the power at death

There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together. *Burnet* v. *Guggenheim*, *supra*, 286. An important, if not the main, purpose of the gift tax was to prevent or compensate for avoidance of death taxes by taxing the gifts of property *inter vivos* which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death.[1]

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[1] The gift tax provisions of the Revenue Act of 1924 were added by amendments to the revenue bill introduced on the floor of the House and the Senate Cong. Rec, Vol 65, Part 3, pp 3118–3119; Part 4, pp 3170, 3171, Part 8, p 8094. The sponsor of the amendment in both houses urged the adoption of the bill as a "corollary" or as "supplemental" to the estate tax. Cong. Rec., Vol 65, Part 3, pp 3119–3120, 3122; Part 4 p.3172, Cong Rec., Vol 65, Part 8, pp.8095, 8096

The gift tax of 1924 was repealed when Congress, concurrently with the enactment of §302(c) of the Revenue Act of 1926, 44 Stat 70, 125, 126, establishing a conclusive presumption that gifts within two years of death were made in contemplation of death and therefore subject

Section 322 of the 1924 Act provides that when a tax has been imposed by §319 upon a gift, the value of which is required by any provision of the statute taxing the estate to be included in the gross estate, the gift tax is to be credited on the estate tax.* The two taxes are thus not always mutually exclusive as in the case of gifts made in contemplation of death which are complete and taxable when made, and are also required to be included in the gross estate for purposes of the death tax. But §322 is without application unless there is a gift *inter vivos* which is taxable independently of any requirement that it shall be included in the gross estate. Property transferred in trust subject to a power of control over its disposition reserved to the donor is likewise required by §302(d) to be included in the gross estate. But it does not follow that the transfer in trust is also taxable as a gift. The point was decided in the *Guggenheim* case where it was held that a gift upon trust, with power in the donor to revoke it is not taxable as a gift because the transfer is incomplete and that the transfer whether *inter vivos* or at death becomes complete and taxable only when the power of control is relinquished. We think, as was pointed out in the *Guggenheim* case, *supra*, 285, that the gift tax statute does not contemplate two taxes upon gifts not made in contemplation of death, one upon the gift when a trust is created or when the power of revocation, if any, is relinquished, and another on the transfer of the same property at death because the gift previously made was incomplete.

It is plain that the contention of the taxpayer in this case that the gift becomes complete and taxable upon the relinquishment of the donor's power to revoke the trust cannot be sustained unless we are to hold, contrary to the policy of the statute and the reasoning in the *Guggenheim* case, that a second tax will be incurred upon the donor's relinquishment at death of his power to select new beneficiaries, or unless as an alternative we are to abandon our ruling in the *Porter* case. The Government does not suggest, even in its argument in the *Humphreys* case, that we should depart from our earlier rulings, and we think it clear that we should not do so both because we are satisfied with the reasoning upon which they rest and because departure from either would produce inconsistencies in the law as serious and confusing as the inconsistencies in administrative practice from which the Government now seeks relief.

There are other persuasive reasons why the taxpayer's contention cannot be sustained. By §§315(b), 324, and more specifically by §510 of the 1932 Act, the donee of any gift is made personally liable for the tax to the extent of the value of the gift if the tax is not paid by the donor.† It can hardly be supposed that Congress intended to impose personal liabilities upon the donee of a gift of

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to the estate tax. A gift tax was reenacted by §501 of the Revenue Act of 1932, 47 Stat. 169, shortly after it was decided in Heiner v. Donnan, 285 U.S. 312, that the legislative enactment of such a presumption violated the Fifth Amendment.

Section 501(c) of the 1932 Act added a new provision that transfers in trust, with power of revocation in the donor, should be taxed on relinquishment of the power. This was repealed by §511 of the Act of 1934, 48 Stat. 680, because Burnet v. Guggenheim, 288 U.S. 280, had declared that such was the law without specific legislation. H.R. No. 704, 73rd Cong., 2d Sess., p.40; Sen Rep. No. 558, 73rd Cong., 2d Sess., p.50.

* The corresponding provision of the 1954 Code is §2012, *infra*, p. 1230. [Ed.]

† See §6324(b), 1954 Code. [Ed.]

property, so incomplete that he might be deprived of it by the donor the day after he had paid the tax. Further, § 321(b)(1) exempts from the tax, gifts to religious, charitable, and educational corporations and the like.* A gift would seem not to be complete, for purposes of the tax, where the donor has reserved the power to determine whether the donees ultimately entitled to receive and enjoy the property are of such a class as to exempt the gift from taxation. Apart from other considerations we should hesitate to accept as correct a construction under which it would plausibly be maintained that a gift in trust for the benefit of charitable corporations is then complete so that the taxing statute becomes operative and the gift escapes the tax even though the donor should later change the beneficiaries to the non-exempt class through exercise of a power to modify the trust in any way not beneficial to himself.

The argument of petitioner that the construction which the Government supports here, but assails in the *Humphreys* case, affords a ready means of evasion of the gift tax is not impressive. It is true, of course, that under it gift taxes will not be imposed on transactions which fall short of being completed gifts. But if for that reason they are not taxed as gifts they remain subject to death taxes assessed at higher rates, and the Government gets its due, which was precisely the end sought by the enactment of the gift tax.

Nor do we think that the provisions of § 219(g) of the 1924 Act† have any persuasive influence on the construction of the gift tax provisions with which we are now concerned. One purpose of the gift tax was to prevent or compensate for the loss of surtax upon income where large estates are split up by gifts to numerous donees.[2] Congress was aware that donors in trust might distribute income among several beneficiaries, although the gift remains so incomplete as not to be subject to the tax. It dealt with that contingency in §219(g) which taxes to the settlor the income of a trust paid to beneficiaries where he reserved to himself an unexercised power to "revest in himself title" to the trust property producing the income. Whether this section is to be read as relieving the donor of the income tax where the power reserved is to modify the trust, except for his own benefit, we do not now decide. If Congress, in enacting it, undertook to define the extent to which a reserved power of control over the disposition of the income is equivalent to ownership of it so as to mark the line between those cases on the one hand where the income is to be taxed to the donor and those on the other where, by related sections, the income is to be taxed to the trust or its beneficiaries, we do not perceive that the section presents any question so comparable to that now before us as to affect our decision. We are concerned here with a question to which Congress has given no answer in the words of the statute, and it must be decided in conformity to the course of judicial decision applicable to a unified scheme of taxation of gifts whether made *inter vivos* or at death. If Congress, for purpose of taxing income, has defined precisely the amount of control over the income which it deems equivalent to ownership of it, that

* See §2522, 1954 Code [Ed.]

† See §676(a), 1954 Code, *supra*, p 315 [Ed.]

[2] See references to Congressional Record, Footnote 1.

definition is controlling on the courts even though without it they might reach a different conclusion, and even though retention of a lesser degree of control be deemed to render a transfer incomplete for the purpose of laying gift and death taxes.

The question remains whether the construction of the statute which we conclude is to be derived from its language and history, should be modified because of the force of treasury regulations or administrative practice. [The Court went on to hold that the regulations were "ambiguous and without persuasive force in determining the true construction of the statute" and that the administrative practice was too inconsistent to be accepted as an expert interpretation of the statute.]

Affirmed.

MR. JUSTICE BUTLER took no part in the consideration or decision of this case.

Note

1. Is a gift tax payable on the creation of a trust of the type involved in *Commissioner* v. *Chase National Bank, supra? Higgins* v. *Commissioner*, 129 F.2d 237 (1st Cir. 1942), cert. den., 317 U.S. 658. Of the type involved in *Commissioner* v. *Estate of Holmes, supra?* Regs. 108, Sec. 86.3.

2. In 1943, the gift tax law was amended to permit, for a limited period, the tax-free relinquishment of "Sanford trust" powers. The "elusive policy of relief" which moved Congress to enact this provision is acidly pursued in Paul, *Federal Estate and Gift Taxation* (1946 Supp.) Sec. 17.07A.

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2. *Where Grantor's Power Is Restricted*

(a) By a requirement of notice or lapse of time

Note

Transferred property is includible under §2038 only if enjoyment "was subject *at the date of* [the decedent's] *death* to any change through the exercise of a power . . . by the decedent." What if the decedent was required to give 12 months' notice of his intention to exercise the power or if the change was to take effect only 12 months after exercise of the power? See §2038(b), explained by the House Committee on Ways and Means (H. Rept. No. 704, 73rd Cong., 2d Sess., 1939–1 C.B. (Part 2) p. 581):

> However, if the retained right to alter, amend, or revoke could be exercised only after a precedent notice of, say, a year, or if the alteration, amendment, or revocation would become effective only after a lapse of time after A performed the act which gave rise to the alteration, amendment, or revocation, it might be contended that under existing law the property is not includible in the decedent's gross estate. While it is believed that such contention would not be well founded, your committee believes it desirable to clarify the law so that under such circumstances it will be entirely clear that all the property of which the decedent at the date of his death has to all intents and purposes practical, if not technical, ownership, is to be included in his gross estate. This section clarifies the existing law on the subject and expressly provides that, although a notice may be required as a condition precedent to exercising the right to alter, amend, or revoke, nevertheless

the full value of the property at the date of the decedent's death must be included in the gross estate, less only the outstanding estate (measured by the period required to elapse between the giving of the notice and the taking effect of any alteration, amendment, or revocation) which at the decedent's death is irrevocably beyond his control.

(b) By a prescribed standard

JENNINGS v. SMITH

U.S. Court of Appeals, Second Circuit, 1947
161 F.2d 74

Before SWAN, CHASE and FRANK, Circuit Judges.

SWAN, Circuit Judge.

This is an action by the executors of the will of Oliver Gould Jennings, a resident of Connecticut whose death occurred on October 13, 1936, to recover such part of the estate tax paid by them to the defendant collector as had been illegally collected. Their right to a refund of the amount claimed is clear under *Maass* v. *Higgins*, 312 U.S. 443, and was not disputed; but the defendant set up in defense an additional estate tax liability (greater than the alleged overpayment) based on the failure to include in the decedent's gross estate the value of certain property which he had transferred in trust in 1934 and 1935. Although assessment of an additional estate tax was barred by the statute of limitations, the plaintiffs do not contend that they are entitled to a refund unless the tax legally due was overpaid. See *Lewis* v. *Reynolds*, 284 U.S. 281. Hence the question presented at the trial and renewed here, is whether the value of the trust property should have been included in the gross estate. The district court held it includible under §811(d) of the [1939] Internal Revenue Code [§2038, 1954 Code]. Accordingly judgment was given for the defendant, and the plaintiffs have appealed.

In December 1934 the decedent set up two trusts: one for the family of his elder son, B. Brewster Jennings, the other for the family of his younger son, Lawrence K. Jennings. The trust instruments were identical, except for the names of the beneficiaries and the property transferred. In discussing the terms of the trusts it will suffice to refer to the one set up for the elder son's family. The trust was irrevocable and in so far as legally permissible its provisions were to be interpreted and enforced according to Connecticut law. It reserved no beneficial interest to the settlor. He and his two sons were named as the trustees; in case a vacancy should occur provision was made for the appointment of a successor trustee having like powers; there were always to be three trustees and they were authorized to act by majority vote. At the end of each year during the life of the son, the trustees were to accumulate the net income by adding it to the capital of the trust but they were given power, "in their absolute discretion" at any time during the year and prior to the amalgamation of that year's net income into capital, to use all or any part of it for the benefit of the son or his issue provided "the trustees shall determine that such disbursement is reasonably necessary to enable the beneficiary in question to maintain himself and his

family, if any, in comfort and in accordance with the station in life to which he belongs." Upon the death of the son the capital of the trust was to be divided into separate equal trust funds, one for each of his surviving children and one for each deceased child who left issue surviving at the death of the son. The trustees also had power to invade the capital upon the terms set out in paragraph 3(f) of the trust deed. In the Lawrence K. Jennings trust all current net income for the years 1935 and 1936 was paid to him, the trustees, of whom the decedent was one, having unanimously determined that such payments were necessary to enable Lawrence to maintain himself and his family in comfort and in accordance with his station in life. No payment or application of income of the B. Brewster Jennings trust, and none of capital of either trust, was made or requested during the life of the decedent.

Gift tax returns covering the transfers in trust were duly filed and taxes paid thereon. The trusts were not created in contemplation of death, nor to reduce estate taxes on the settlor's estate.

Section 811(d)(2) of the Code, which is applicable to transfers made before June 22, 1936, provides for inclusion in the gross estate of all property "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, . . ."

The appellants contend that this section embraces only powers exercisable by the settlor in his individual capacity and does not include powers exercisable by him in a fiduciary capacity, either alone or as one of several trustees. Under §811(d)(1), which relates to transfers made after June 22, 1936, the existence of a power to alter, amend or revoke "(in whatever capacity exercisable)" is sufficient. Whether the quoted parenthetical phrase was intended to effect a change or was declaratory of existing law was left open in *Commissioner* v. *Estate of Holmes*, 326 U.S. 480, at page 490. But in *Commissioner* v. *Newbold's Estate*, 2 Cir., 158 F.2d 694, this court recently held, following the first and third circuits, that the phrase was merely declaratory and its absence from §811(d)(2) is consequently not significant. Despite the appellants' able argument to the contrary, we adhere to that view.

The next question is whether the powers conferred upon the trustees in the case at bar are powers of the character described in section 811(d)(2), which requires that enjoyment of the trust property must be subject at the date of the decedent's death to change through the exercise of a power. The trustees' power to invade the capital of the trust property was exercisable only if the son or his issue "should suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary." Neither of these contingencies had occurred before the decedent's death; hence enjoyment of the capital was not "subject at the date of his death to any change through the exercise of a power." In *Commissioner* v. *Flanders*, 2 Cir., 111 F.2d 117, although decision was rested on another ground, this court expressed the opinion that a power conditioned upon an event which had not occurred before the settlor's death was not within the section. In support of this view we cited *Tait* v. *Safe Deposit & Trust Co.*, 4 Cir., 74 F.2d 851, 858; *Day* v. *Commissioner*, 3 Cir., 92 F.2d 179; *Patterson* v.

Commissioner, 36 B.T.A. 407. The question has recently been explored by the Tax Court in *Estate of Budlong* v. *Commissioner*, 7 T.C. 758.* There it was held in a convincing opinion that the power of trustees to invade corpus in case of "sickness or other emergency," which had not occurred before the decedent's death, was not a power to "alter, amend or revoke" within the meaning of the statute. The court reasoned that the trustees had not unlimited discretion to act or withhold action under the power, since the trust instrument provided an external standard which a court of equity would apply to compel compliance by the trustees on the happening of the specified contingency or to restrain threatened action if the condition were not fulfilled. In the case at bar the district judge was of opinion that even if the trustees found that the stated conditions had been fulfilled, "their finding created no enforcible rights in any of the beneficiaries." 63 F.Supp. 834, at page 837. In this view we are unable to concur. The condition upon which the power to invade capital might arise is sufficiently definite to be capable of determination by a court of equity. As Judge L. Hand said in *Stix* v. *Commissioner*, 2 Cir., 152 F.2d 562, 563, "no language, however strong, will entirely remove any power held in trust from the reach of a court of equity."... Since the trustees were not free to exercise untrammeled discretion but were to be governed by determinable standards, their power to invade capital, conditioned on contingencies which had not happened, did not in our opinion bring the trust property within the reach of section 811(d)(2).

Similar reasoning leads to the same conclusion with respect to the trustees' power over net income. At the end of each calendar year they were to accumulate the net income of that year unless prior to its amalgamation into capital they exercised their power to disburse it to, or for the benefit of, the son or his issue. The power the trustees had with respect to disbursing income was exercisable year by year; and at the date of the decedent's death the only income of which the enjoyment was subject to change through exercise of a power was the income of the B. Brewster Jennings trust for the year 1936. But the exercise of this power was conditioned on the trustees' determination that disbursement of the income was necessary to enable the beneficiary to whom it might be allotted to maintain himself and his family "in comfort and in accordance with the station in life to which he belongs." The contingency which would justify exercise of the power had not happened before the decedent's death; consequently the 1936 net income of the B. Brewster Jennings trust was not subject at the date of the decedent's death "to any change through the exercise of a power." Hence it was not includible in the gross estate of the decedent under §811(d). This conclusion is not inconsistent with *Commissioner* v. *Newbold's Estate*, 2 Cir., 158 F.2d 694, for there the trustees had unlimited discretion, the trust instrument expressly providing that no beneficiary should have any vested right to receive any payment from income...

The judgment is reversed and the cause remanded with directions to enter judgment for the plaintiffs.

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* Aff'd in part, rev'd in part, *sub nom.* Industrial Trust Co. v. Commissioner, *infra*, p. 1118. [Ed.]

Note

1. If before the decedent's death the beneficiary had suffered "prolonged illness" or had been "overtaken by financial misfortune," would the corpus, or part of it, have been includible as the court interprets §2038? In connection with the court's statement that a contingent power is not within the reach of §2038 if the contingency has not occurred before the decedent's death, see Regs. 105, Sec. 81.20(b)(3), taking the position that a power to alter, amend or revoke "will be considered to have existed on the date of the decedent's death . . . though the exercise of the power was restricted to a particular time which had not arrived or the happening of a particular event which had not occurred, at decedent's death."

2. How restricted was the discretion of the trustees? See *Estate of Wilson* v. *Commissioner*, 13 T.C. 869 (1949), aff'd p.c. 187 F.2d 145 (3d Cir. 1951), holding that the following clause embodied an "adequate external standard" to govern the discretion of the trustee: "The Trustee may in its absolute discretion accelerate payments of interest or principal in case of need for educational purposes or because of illness or for any other good reason." See also *Estate of Wier* v. *Commissioner*, 17 T.C. 409, 418–20 (1951), holding that the following clause was sheltered by *Jennings* v. *Smith*: ". . . the Trustees [the decedent and his brother] shall expend from time to time as they may deem necessary or proper for the support, maintenance and education of [the decedent's daughter] such sum or sums as such Trustees shall in their sole discretion consider to the interest and advantage of [the beneficiary] . . . . [The beneficiary] shall be properly maintained, educated and supported in the manner appropriate to her station in life, and if, in the discretion and judgment of the said Trustees, it be necessary to that end, at any time or times, to use all of the income or even all of the corpus of the trust estate hereby created and all augmentations thereof, it shall be the duty of the Trustees to see that [the beneficiary] shall be properly maintained, educated and supported." (It was apparently not contemplated that any of the income or corpus would be so distributed, because the beneficiary was otherwise adequately provided for, but the Tax Court did not rest on this ground.)

A contrary result was reached in *Hurd* v. *Commissioner*, 160 F.2d 610 (1st Cir. 1947), where the trustees could pay over the corpus of a trust to the decedent-grantor's wife "if in their opinion the circumstances so require." The court said:

> The word "circumstances," as used in the trust instrument, is as wide as the world and to say that it imposes a legal limitation, or imports a controlling contingency, is to stretch it far beyond good sense. We entertain grave doubts that any equity court would harken to the complaints of a disaffected cestui who might interpose objections to the decedent's invasion of the principal for the use of his wife, irrespective of the "circumstances." The clause is not restricted to "her" circumstances, but rather to "the" circumstances. It is difficult to think of a much broader reservation of powers. . . .

See also *Estate of Yawkey* v. *Commissioner*, *infra*, p. 1125, holding that a power to be exercised "in the best interest of the beneficiary" is not protected by *Jennings* v. *Smith*.

In *Theopold* v. *United States*, 164 F.2d 404 (1st Cir. 1947), the court said of a power retained by the settlor of a trust "to amend this trust instrument so that it will more clearly express my actual intentions if I shall consider such amendment advisable, as to which I shall be the sole judge":

> . . . the reserved power as we construe it, while a power to amend in the sense of altering language so as more clearly to express an original intention, is not a power to amend in the sense of altering language to express a new or different intention. And so construed we consider it, if in the statutory sense a power to amend at all, to be a power to make only "slight" or "trivial" changes in the trust instrument and hence not a power within the meaning of the taxing statute . . . (164 F.2d at 404.)

3. See Pedrick, "The Artful Dodger Faces Life and Looks at Death," 28 *Taxes* 1151 (1950).

(c) By a requirement that others join in grantor's action

HELVERING v. CITY BANK FARMERS TRUST CO.

Supreme Court of the United States, 1935
296 U.S. 85

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The questions for decision are whether §302(d) of the Revenue Act of 1926 [identical with §2038(a)(2) of the 1954 Code] requires inclusion in the gross estate of the value of the corpus of a trust established in 1930 where the creator reserved a power to revoke or modify, to be exercised jointly with a beneficiary and the trustee; and whether, if such value is to be included in the gross estate, the section offends the Fifth Amendment.

By a writing dated February 21, 1930, Gertrude Feldman James, a non-resident citizen, transferred securities to the respondent as trustee, the trust to last during the lives of her two daughters or the survivor of them. The income was to be paid to her until her death, or until the termination of the trust, whichever should first occur. After her death, her husband surviving, the income was to be paid to him. If he did not outlive her, or upon his death, the income was to be distributed amongst their issue per stirpes. At the termination of the trust the corpus was to be delivered to the husband, if he were alive, if not, to the settlor, if living, or, if she were dead, to the beneficiaries at that time entitled to receive the income; if there were none such, to the heirs at law of the husband. The trust was irrevocable save that the settlor reserved the right to modify, alter or revoke it, in whole or in part, or to change any beneficial interest, any such revocation or alteration to be effected with the written consent of the trustee and her husband or, if the husband were dead, of the trustee and her husband's brother. If they could not agree the decision of the husband or of the brother, as the case might be, was to be final Samuel James, the husband, survived the grantor, whose death occurred before the termination of the trust, and he is in receipt of the income.

The petitioner included the value of the corpus of the trust in Mrs. James' gross estate and determined a deficiency of tax. The Board of Tax Appeals reversed, holding that §302(d) did not apply. The Circuit Court of Appeals affirmed the Board's decision. We granted the writ of certiorari because the decision below conflicts with that in another circuit. We hold that the section covers this case and as so applied is valid.

The Circuit Court of Appeals thought our decision in *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339, required the language of the Act to be construed as tantamount to "in conjunction with any person not a beneficiary." So limited it is inapplicable to the trust in question.

The *Reinecke* case involved §402(c) of the Revenue Act of 1921 (substantially §302(c) of the Revenue Act of 1926) which directed the inclusion in the gross estate of all property "To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . ." It was held that a gift beyond the power of

the grantor to alter, amend or revoke could not be said to take effect in possession or enjoyment at or after his death. Conversely, one which he alone held the power to revoke or modify came within the section, since, at his death, substantial interests passed from his control and were for the first time confirmed in others. The case involved nothing more than a determination whether the transfers were complete when made. If they were the statute did not reach them.* Here we have a different problem, for §302(d) of the 1926 Act on its face embraces Mrs. James' transfer, although complete when made and thereafter beyond her own unfettered control.

The respondent says that the section ought to be construed in the light of the analogous §219(g).† The latter, part of the income tax title. is "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." The two sections have a cognate purpose but they exhibit marked differences of substance. The one speaks of a power to be exercised with one not a beneficiary, the other of a power to be exercised with any person. The one refers to a power to revest the corpus in the donor; the other has no such limitation. It is true, the Report of the Ways and Means Committee on §302(d) said: "this provision is in accord with the principle of Section 219(g) of the bill which taxes to the grantor the income of a revocable trust." But to credit the assertion that the difference in phraseology is without significance and in both sections Congress meant to express the same thought, would be to disregard the clear intent of the phrase "any person" employed in §302(d). We are not at liberty to construe language so plain as to need no construction, or to refer to Committee reports where there can be no doubt of the meaning of the words used. The section applies to this transfer.

We are next told that if the Act means what it says it taxes a transfer as one taking effect at death though made prior to death and complete when made; that to do this is arbitrary and deprives the taxpayer of property without due process.

The section was first introduced into the Revenue Act of 1924, and reenacted in that of 1926. Mrs. James created her trust in 1930. She was, therefore, upon notice of the law's command, and there can be no claim that the statute is retroactive in its application to her transfer.

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* *Reinecke* v. *Northern Trust Co.* was decided under the Revenue Act of 1921, which, as indicated *supra*, p. 1061, covered only transfers in contemplation of death or "intended to take effect in possession or enjoyment" at or after the transferor's death. The Court held that two trusts revocable by the grantor alone came within this language, but that five other trusts whose revocation required the consent of the beneficiaries were not reached by the statute. As to these five trusts, the Court said·

"Since the power to revoke or alter was dependent on the consent of the one entitled to the beneficial and consequently adverse, interest, the trust, for all practical purposes, had passed as completely from any control by decedent which might inure to his own benefit as if the gift had been absolute."

See Regs. 105, Sec. 81.20(b)(1). Since 1924, however, the statute has expressly reached transfers if enjoyment was subject to a power to alter, amend, or revoke, exercisable by the decedent alone or in conjunction with any person. [Ed.]

† See §676(a), 1954 Code; *supra*, p.315 [Ed.]

The inquiry is whether it is arbitrary and unreasonable to prescribe for the future that, as respects the estate tax, a transfer, complete when made, shall be deemed complete only at the transferor's death, if he reserves power to revoke or alter exercisable jointly with another.

The respondent insists that a power to recall an absolute and complete gift only with the consent of the donee is in truth no power at all; that in such case the so-called exercise of the power is equivalent to a new gift from the donee to the donor. And so it is claimed that the statute arbitrarily declares that to exist which in fact and law is nonexistent. The position is untenable. The purpose of Congress in adding clause (d) to the section as it stood in an earlier act was to prevent avoidance of the tax by the device of joining with the grantor in the exercise of the power of revocation someone who he believed would comply with his wishes. Congress may well have thought that a beneficiary who was of the grantor's immediate family might be amenable to persuasion or be induced to consent to a revocation in consideration of other expected benefits from the grantor's estate. Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The test of validity in respect of due process of law is whether the means adopted are appropriate to the end. A legislative declaration that a status of the taxpayer's creation shall, in the application of the tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, if reasonably requisite to prevent evasion, does not take property without due process. But if the means are unnecessary or inappropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guarantee of due process is infringed.

Illustrations are not lacking of cases falling on either side of the line.

Congress may require that property transferred in contemplation of death, although the transfer is so remote in time as not to comply with the requirements of a gift *causa mortis*, shall nevertheless be treated as part of the estate for purposes of taxation· this for the prevention of evasion and the giving of practical effect to the exercise of admitted power. This is true despite the fact that the statutory prescription embraces gifts *inter vivos* which are in fact fully executed, irrevocable and cannot be defeated.

Although property received by gift from another is capital in the hands of the donee, the gain upon a sale may be measured by the cost to the donor rather than the value at the time of acquisition by the donee.

It is competent for Congress, in order to avoid the evasion of tax, to declare that when one has placed his property in trust subject to a right of revocation in himself and another who is not the beneficiary he shall, nevertheless, be deemed to control the property in such sense that the income therefrom shall be treated as his income for the levying of a tax. So also where an irrevocable trust is established to pay for insurance on the settlor's life, to collect the policy upon his death, and to hold or apply the proceeds for the benefit of his dependents, Congress may declare the income of the trust fund taxable to the settlor as part of his own income.

In the instances cited the power to levy an excise upon the testamentary transfers or to tax income was conceded. To effectuate the exercise of this admitted

power and to prevent evasion Congress was held to have acted reasonably in including within the sweep of the statute a status or an act not normally within its reach.

There are, however, limits to the power of Congress to create a fictitious status under the guise of supposed necessity. Thus it has been held that an act creating a conclusive presumption that a gift made within two years prior to death was made by the donor in contemplation of death, and requiring the value of the gift to be included in computing the estate of the decedent subject to transfer tax, is so grossly unreasonable as to violate the due process clause of the Fifth Amendment. In the same category falls a statute seeking to tax the separate income of a wife as income of her husband.

In view of the evident purpose of Congress we find nothing unreasonable or arbitrary in the provisions of §302(d) of the Revenue Act of 1926 as applied in the circumstances of this case. It was appropriate for Congress to prescribe that if, subsequently to the passage of that Act, the creator of a trust estate saw fit to reserve to himself jointly with any other person the power of revocation or alteration, the transaction should be deemed to be testamentary in character, that is, treated for the purposes of the law as intended to take effect in possession or enjoyment at the death of the settlor.

The judgment is reversed.

MR. JUSTICE VAN DEVANTER, MR. JUSTICE MCREYNOLDS, MR. JUSTICE SUTHERLAND and MR. JUSTICE BUTLER are of opinion that the judgment should be affirmed.

Note

Because §2038 speaks of a power exercisable "by the decedent alone or by the decedent in conjunction with any other person," a power vested in a third person alone is not charged against the grantor by the estate tax law. In determining whether the *income* of a trust is taxable to the grantor, however, a power vested in a "non-adverse party" is ordinarily treated as though it were held by the grantor himself. §§674–677; *supra*, pp. 309–329. There are some exceptions. §§674(c) and (d); §675(3). Is there any reason why powers held by a non-adverse person should ordinarily be imputed to the grantor for income tax purposes, but not under the estate tax? Could a third person be treated as the decedent's alter ego under §2038? See *Delaney* v. *Gardner*, 204 F.2d 885 (1st Cir. 1953), *Kneeland* v. *Commissioner*, 34 B.T.A. 816 (1936).

A third person (at least if he is not the decedent's alter ego), then, may be entrusted with a power to withhold the income or corpus of a trust from the named beneficiaries and to make distributions to the grantor instead, without bringing the corpus into the gross estate under §2038. Nor could the corpus be included under §2033 if the decedent can receive distributions only in the uncontrolled discretion of the third person. Can the grantor go a step farther, and restrict the third person's discretion by providing, for example, that he shall exercise the power if the grantor suffers financial reverses or incurs extraordinary medical expenses? A line of cases holds that if the third person's power is restricted by a definite external standard, so that the grantor could compel him to act when the contingency occurs, part or all of the trust corpus is subject to estate tax. *Blunt* v. *Kelly*, 131 F.2d 632 (3d Cir. 1942); *Bankers Trust Co.* v. *Higgins*, 136 F.2d 477 (2d Cir. 1943); *Estate of Rosenwasser* v. *Commissioner*, 5 T.C. 1043 (1945). These cases rest on old §811(c), requiring the inclusion in the gross estate of transfers intended to take effect in possession or enjoyment at or after the transferor's death, rather than on what is now §2038.* Would §2038 reach such transfers, on the ground

* See *supra*, p. 1061

that the grantor's power to compel the third person to distribute income or corpus to him when the contingency occurs is a power to "alter, amend, or revoke"? Remember that in *Jennings* v. *Smith*, *supra*, p. 1079, involving a cognate problem, the court held that a power exercisable only upon the occurrence of a stipulated event was not embraced by §2038 if the event had not occurred at the time of the decedent's death.

HELVERING v. HELMHOLZ

Supreme Court of the United States, 1935
296 U.S. 93

MR. JUSTICE ROBERTS delivered the opinion of the Court.

This case, like *Helvering* v. *City Bank &c. Tr. Co.*, *ante*, p 85, arises under §302(d) of the Revenue Act of 1926. The respondent is administrator and sole beneficiary of the estate of his wife, Irene C. Helmholz. In 1918 she, her father and mother and her brothers and sisters joined in an indenture conveying to a trustee all of the shares of stock in the Patrick Cudahy Family Company. Her contribution was 999 shares, the dividends from which the trustee was to receive, and pay, less expenses, to Mrs. Helmholz for life, remainder to her appointee by will and remainder to her issue; and in event she or any other subscriber should die without issue the net dividends on the stock delivered to the trustee by such decedent were to be paid "to the surviving subscribers or their issue living at the time of distribution proportionately by right of representation."

The paragraph of the indenture relative to the termination of the trust is

Fifth The term of the primary trust hereby created shall end (1) upon the death of the last surviving grandchild of Patrick and Anna M. Cudahy, they being then deceased, or (2) upon delivery to the said trustee of a written instrument signed by all of the then beneficiaries, other than testamentary appointees, declaring said trust term at an end, or (3) upon delivery to said trustee of a copy (certified by the president or secretary of the Patrick Cudahy Family Company and under its corporate seal) of a resolution adopted by unanimous vote of the board of directors of said corporation declaring said trust term at an end, whereupon and in either of said events the said trustee shall distribute the capital stock of said the Patrick Cudahy Family Company to the beneficiaries then entitled to receive the net dividends thereof other than testamentary appointees, excepting the shares to the dividends upon which such testamentary appointees are entitled, which shall be held by said trustee as hereinbefore provided.

The term of the primary trust hereby created shall also terminate upon the dissolution of said the Patrick Cudahy Family Company in the manner and for any of the causes provided by law, whereupon the trustee shall distribute all the proceeds and assets by it received upon the liquidation of said corporation to the beneficiaries other than testamentary appointees then entitled to receive net dividends or income in the proportion in which they are severally entitled, excepting the proceeds and (or) assets of shares to the net dividends or income upon which testamentary appointees are entitled, which shall continue to be held in trust as hereinbefore provided.

The term of the primary trust hereby created shall also terminate upon the extinction of issue of the said Patrick and Anna M Cudahy, they being then deceased, whereupon the said trustee shall convey and transfer the stock of said the Patrick Cudahy Family Company to the Wisconsin Trust Company as trustee, to have and to hold the same upon the trusts and for the uses and purposes embraced in a certain resolution or declaration of trust adopted by the board of directors of the Wisconsin Trust Company May 24, 1915, establishing a certain community trust known as the Milwaukee Foundation for administration and distribution as in said trust declaration prescribed and

defined, subject, however, to any existing valid testamentary appointments made by subscribers hereto as hereinbefore provided.

Irene C. Helmholz left a will bequeathing all her property to respondent. The Supreme Court of Wisconsin held this a valid exercise of her power of appointment under the trust deed. [*First Wisconsin Trust Co.* v. *Helmholz,* 198 Wis. 573; 225 N.W. 191.] The petitioner determined that the value of the 999 shares should be included in her gross estate. The Board of Tax Appeals reversed this determination. The United States Court of Appeals for the District of Columbia, to which an appeal was taken pursuant to stipulation for hearing by that court, affirmed the Board. We granted certiorari.

What is said in *Helvering* v. *City Bank & Tr. Co., supra,* shows that the transfer was complete when the trust was created in 1918. The features which differentiate this case are the absence of a reserved power of revocation or alteration and the retroactive operation of the Act. Either requires a decision that the corpus of the trust may not be included in the gross estate.

The words of §302(d) are, "where the enjoyment [of the transfer] was subject at the date of his death to any change *through the exercise of a power,* either by the decedent alone or in conjunction with any person, *to alter, amend or revoke. . . .*" The agreement under consideration contains no such power as that described. Like every well drawn instrument it embodies provisions for the termination of the trust. An examination of paragraph Fifth shows that these were, in the main, such as any farsighted settlor would employ. Since the beneficiaries were the issue of Patrick and Anna Cudahy it was natural to provide that upon the extinction of issue the trust should terminate and the principal be turned over to a secondary charitable trust. Inasmuch as the corpus comprised only the shares of a corporation there was nothing out of the ordinary in requiring that the trust terminate upon dissolution of the company and that the proceeds of liquidation be distributed amongst the then beneficiaries. It was not unnatural to direct that the trust should end if the managers of the company should unanimously so decide. And termination upon the death of the last surviving grandchild of Patrick and Anna Cudahy, they being then deceased, is certainly not unusual.

The petitioner, however, pitches upon the only remaining event of termination, asserting it to be the equivalent of a power to revoke, or to amend, to be exercised by the settlor with others. This is found in the clause providing that the delivery to the trustee of a writing signed by all the then beneficiaries (other than testamentary appointees) declaring such purpose, shall be effective to end the trust. He points out that such a writing might have been executed by Mrs. Helmholz and her co-beneficiaries while she was alive, with the effect of revesting in her the shares which she had delivered into the trust. This argument overlooks the essential difference between a power to revoke, alter or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

Another and more serious objection to the application of §302(d) in the present

instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter or to amend. Under the revenue act then in force the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339. If §302(d) of the Act of 1926 could fairly be considered as intended to apply in the instant case its operation would violate the Fifth Amendment. *Nichols* v. *Coolidge*, 274 U.S. 531.

The judgment is affirmed.

MR. JUSTICE BRANDEIS, MR. JUSTICE STONE and MR. JUSTICE CARDOZO concur in the result on the ground last stated in the opinion.

Note

1. The United States argued that this case "presents the precise question involved in *Helvering* v *City Bank Farmers Trust Co.*" and incorporated by reference the brief in that case without additional argument. Brief for the petitioner, p. 7.

2. Termination of the Helmholz trust could be accomplished by the living beneficiaries, despite the possibility that persons yet unborn would become beneficiaries Although this is the law of New York (*Smith* v *Title Guarantee & Trust Co*, 287 N.Y. 500, 41 N.E.2d 72 (1942), interpreting § 23 of the N.Y. Personal Property Law), it is not ordinarily possible to cut off the rights of unborn or unascertained beneficiaries —unless the trust instrument so provides. Scott, *The Law of Trusts*. Sec 340. *Cf* Lowndes, "Federal Taxation of North Carolina Trusts for Unborn and Unascertained Beneficiaries," 20 *No. Car. L. Rev* 278 (1942), which was followed by an amendment of the North Carolina law, with *Estate of Coulter* v. *Commissioner*, 7 T.C. 1280 (1946), and *Estate of Seltzer* v. *Commissioner*, 10 T.C. 810 (1948). Does the phrase "all the parties having an interest, vested or contingent" as employed in Regs. 105, Sec. 81 20 (last paragraph) mean the same as 'all the persons beneficially interested" as used in Section 23 of the New York Personal Property Law, *viz.*, "all *living* persons beneficially interested" (see *Smith* v. *Title Guarantee & Trust Co., supra*)?

CAMP v. COMMISSIONER

U.S. Court of Appeals, First Circuit, 1952
195 F.2d 999

Before MAGRUDER, Chief Judge, and WOODBURY and HARTIGAN, Circuit Judges.

MAGRUDER, Chief Judge.

Frederic E Camp petitions for review of a decision of the Tax Court entered November 7, 1950, holding that petitioner was deficient in his gift tax for the year 1937 in the amount of $55,737 08. and for the year 1943 in the amount of $1,839.99. Primarily, the issue relates to the year 1937, the Tax Court's determination as to 1937 resulted in an upward revision of the figure for taxpayer's net gifts for the years prior to 1943, and thus, as a mere matter of mathematical computation, in a determination of a deficiency in taxpayer's gift tax liability for other gifts made by him in 1943.

The dispute centers about the effect of a transfer in trust made by the taxpayer in 1932, prior to the enactment of the Revenue Act of 1932, §501 of which im-

posed a tax on gifts. Petitioner insists that this transfer in trust was a completed gift of the whole corpus, so that the transaction in its entirety was outside the incidence of the gift tax subsequently enacted. The Tax Court has held, however, that there was no completed gift at all in 1932, because the donor reserved in the deed of trust full power to alter, amend or revoke, in conjunction with his half brother, who, the court concluded, had no "substantial adverse interest" in the trust property; and that there was a completed gift of the whole of the corpus of the trust in 1937, when the trust instrument was amended so as to vest the power of further amendment or revocation in the donor in sole conjunction with the donor's wife, who had a life interest in the trust income.

We are unable to accept altogether either the taxpayer's argument or the conclusion of the Tax Court. This segment of tax law, as to when a transfer in trust is to be deemed a completed gift for purposes of the gift tax, has been in a somewhat cloudy state, as perhaps is evident from the fact that in the present case the Commissioner has taken several successive positions, each asserting a larger deficiency for the years in question.

The case was tried in the Tax Court upon a stipulation of facts, supplemented by a deposition by petitioner which was read into evidence.

On October 30, 1931, the taxpayer married Alida Donnell Milliken. No children have issued from this marriage; but at various dates within the period January 19, 1937, to October 3, 1942, taxpayer and his wife have adopted four children.

On February 1, 1932, taxpayer executed a trust indenture naming Bankers Trust Company of New York as trustee, and transferred to said trustee, as corpus of the trust, securities then having a fair market value of $416,131.72

The trust instrument provided that the income should be payable to taxpayer's wife Alida during her life, and that upon her death the principal of the trust should be paid to the then living issue of the donor *per stirpes;* and in default of such issue, that the trustee should continue to hold the principal in trust, paying the income therefrom to Johnanna R. Bullock, mother of the donor, during her life, and upon her death, that the trustee should pay the principal of the trust fund unto H. Ridgely Bullock, half brother of the donor, or if he be then dead, unto the then living issue of said H. Ridgely Bullock *per stirpes*, or if there be none, to the trustees of Princeton University.

The tenth article of the trust indenture provided:

> This indenture shall not be subject to revocation, alteration or modification by the Donor, alone, but nevertheless, he may, in conjunction with either H. Ridgely Bullock or Johnanna R. Bullock, beneficiaries hereunder, during the continuance of this trust, by instrument, in writing, executed and acknowledged by the Donor and either the said H. Ridgely Bullock or the said Johnanna R. Bullock, . . . modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created. . . .

When the trust was thus created in February, 1932, taxpayer's wife Alida was 23 years of age, his mother Johnanna R. Bullock was 63, and his half brother H. Ridgely Bullock was 22.

On August 30, 1934, the taxpayer, in conjunction with Ridgely, exercised the power to alter or amend by inserting a provision that Alida, wife of the donor, should receive the income of the trust only so long as she, during the donor's lifetime, should continue to be his wife and to reside with him.

On December 11, 1937, the taxpayer, in conjunction with Ridgely, exercised the amendatory power so as to provide that the term "issue of the Donor," as used in the trust instrument, should be deemed to include any child or children then or thereafter legally adopted by the donor and his said wife, and their issue. At the same time the trust instrument was further modified so as to strike out the above-quoted provision in the tenth article with reference to the power to alter, amend or revoke, and to substitute in lieu thereof a provision containing the same words except that the name of Alida Donnell Milliken Camp was substituted for the names of H. Ridgely Bullock and Johnanna R. Bullock. Thus, on and after December 11, 1937, taxpayer reserved the power to alter, amend or revoke the trust in sole conjunction with his wife Alida, who was entitled to all the income from the trust during her lifetime, with the qualification previously stated.

The fair market value of the corpus of the trust, as of December 11, 1937, was $518,089.76.

On June 6, 1946, the taxpayer, in conjunction with his wife Alida, further modified the trust instrument by striking out in its entirety the provision of the tenth article, as amended, dealing with the power to alter, amend or revoke, and substituting in lieu thereof an unqualified provision that the trust indenture "shall not be subject to revocation, alteration or modification."

Section 501(c) of the Revenue Act of 1932 contained the following specific provision:

> The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift.

This subsection was repealed in 1934, 48 Stat 758, for the reason, as explained in the committee reports, that "the principle expressed in that section is now a fundamental part of the law by virtue of the Supreme Court's decision in the *Guggenheim* case . . ." *

It is to be noted that the facts of the *Guggenheim* case were narrower than the situations specifically covered in §501(c), in that the Supreme Court was not passing upon the case where the donor did not reserve to himself alone the power of revocation, but vested such power in himself in conjunction with some other person who might or might not have had a substantial adverse interest in the disposition of the property or the income therefrom. However, the committee reports in 1934 expressed the view that this latter situation was covered in principle by the Supreme Court's decision in the *Guggenheim* case, and therefore recommended the repeal of § 501 (c) because it had become unnecessary and superfluous.

What, then, was this "principle" recognized in the *Guggenheim* case? We think it is to be found in the Court's opinion, 288 U S. at 286, that the gift tax

* *Supra*, p 913 [Ed]

was not aimed at every transfer of the legal title without consideration, which would include a transfer to trustees to hold for the use of the grantor, but was aimed, rather, "at transfers of the title that have the quality of a gift, and a gift is not consummate until put beyond recall."

Subsequent cases have elaborated upon this concept of a "gift," and have settled that a transfer in trust is incomplete as a gift, not only where the donor reserves the power to revest the trust property in himself, but also where he reserves the power to alter the disposition of the property or the income therefrom in some way not beneficial to himself. *Estate of Sanford* v. *Commissioner*, 1939, 308 U.S. 39, *Rasquin* v. *Humphreys*, 1939, 308 U.S. 54. See the discussion in *Higgins* v. *Commissioner*, 1 Cir., 1942, 129 F.2d 237.

Treasury Regulations 108 contain the following provisions, which we take to be declaratory of the intent of the Act and of the gloss which later cases have put upon the concept of a "gift" as expressed in *Burnet* v. *Guggenheim:*

> §86.3. Cessation of donor's dominion and control. . . .
>
> As to the property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change the disposition thereof, whether for his own benefit or for the benefit of another, the gift is complete, But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over the disposition thereof, the gift may be wholly incomplete, or may be partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.
>
> A gift is incomplete in every instance where a donor reserves the power to revest the beneficial title to the property in himself A gift is also incomplete where and to the extent that a reserved power gives the donor the right to name new beneficiaries or to change the interests of the beneficiaries as between themselves. . . .
>
> A donor shall be considered as himself having the power where it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income
>
> The relinquishment or termination of a power to change the disposition of the transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event which completes the gift and causes the tax to apply. . . .

Where a donor makes a transfer in trust for numerous beneficiaries, it is obvious that there may be several distinct gifts or potential gifts. For purposes of the gift tax, some of the interests created may be completed gifts, and others may not be, depending upon the facts of the particular case—as is stated in the first paragraph of the above quotation from §86.3 of the regulations.

From the foregoing, we think the following propositions are reasonably clear:

(1) If the trust instrument gives a designated beneficiary any interest in the corpus of the trust property or of the income therefrom, which is capable of monetary valuation, and the donor reserves no power to withdraw that interest, in whole or in part, except with the consent of such designated beneficiary, then the gift of that particular interest will be deemed to be complete, for the purposes of the gift tax. See accord, our discussion in *Commissioner* v. *Prouty*, 1 Cir., 1940, 115 F.2d 331, 334, 131 A.L.R. 977, with reference to the annuities to the husband in Trusts 2 and 3. This is true, though at the time of the creation of the trust there

might be extraneous considerations, whether of a pecuniary or sentimental nature, which would give the donor every confidence that such designated beneficiary would acquiesce in any future desire of the donor to withdraw the gift, in whole or in part. See *Commissioner* v. *Prouty*, *supra* at page 335–336.* In that respect the donor is taken at his word; he has legally given away something which he cannot take back except with the consent of the donee. The transfer fulfills the concept of a completed gift, quite as much as if a husband makes an outright gift of securities to his wife, being confident that his wife would reconvey the securities to him if he ever asked for them. If there were an advance agreement between the donor and the donee, prior to the transfer in trust, to the effect that the donee would acquiesce in any future exercise of the power of modification proposed by the donor, then the situation would be different. The trust instrument would not express the true intention of the parties. A real gift is not intended, where the purported donee has agreed ahead of time to hold the "gift" subject to the call and disposition of the purported donor.[1]

(2) If the only power reserved by the donor is a power to revoke the entire trust instrument (not a power to modify the trust in any particular), and this power may be exercised only in conjunction with a designated beneficiary who is given a substantial adverse interest in the disposition of the trust property or the income therefrom, then the transfer in trust will be deemed to be a present gift of the entire corpus of the trust, for purposes of the gift tax. In such cases, the gift of the entire corpus will be deemed to have been "put beyond recall" by the donor himself.

(3) If the trust instrument reserves to the donor a general power to alter, amend or revoke, in whole or in part and this power is to be exercised only in conjunction with a designated beneficiary who has received an interest in the corpus or income capable of monetary valuation, then the transfer in trust will be deemed to be a completed gift, for purposes of the gift tax, only as to the interest of such

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* "Examining these intimate family trusts, one must recognize an element of unreality in the inquiry whether a beneficiary's interest is substantially adverse to the grantor The supposition is that, given a sufficient stake in the trust, the beneficiary is not likely to yield to a wish of a grantor to revoke the trust In many cases the grantor may have full confidence in the compliant disposition of the member of the family he selects to share his power of revocation, even though such member is named as beneficiary of a handsome interest in the trust The very fact that the grantor reserved a power to revoke indicates a mental reservation on his part as to the finality of the gift, and if the grantor wishes to hold on to a power of recapture, it stands to reason he will vest the veto power in someone whose acquiescence he can count on *Cf Helvering* v. *City Bank Farmers Trust Co*, 296 U S 85, 90 However, we cannot read into the gift tax, any more than into Sections 166 and 167 [1939 Code], the proposition that a member of the grantor's immediate family can never be deemed to have 'a substantial adverse interest' So far as the gift tax is concerned, it is fair enough to take the grantor at his word As to the income tax, it might be rational for Congress to tax all family income as a unit But as the law now stands- both gift tax and income tax—we must give weight to the formal rights conferred in the trust instrument in determining whether a given beneficiary has a substantial adverse interest, bearing in mind the admonition of *Helvering* v. *Clifford*, 309 U S 331, 335, that where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary . . ."

[1] In the present case, the Tax Court inferred from petitioner's deposition, which was read in evidence, that there was such an advance agreement here between petitioner and his half brother Ridgely. In the view we take, it is unnecessary for us to determine whether such an inference of fact was warranted.

designated beneficiary having a veto over the exercise of the power.[2] As to the interests of the other beneficiaries, the gifts will be deemed to be incomplete, for as to such interests the donor reserves the power to take them away in conjunction with a person who has no interest in the trust adverse to such withdrawal. The gifts to the other beneficiaries have not been "put beyond recall" by the donor; in such cases the regulation recognizes realistically that when the donor has reserved the power to withdraw any of the donated interests with the concurrence of some third person who has no interest in the trust adverse to such withdrawal, it is in substance the same as if the donor had reserved such power in himself alone. In further support of this proposition, see the discussion in *Estate of Sanford* v. *Commissioner*, 1939, 308 U.S. 39, 46–47.

Coming back, then, to the terms of the trust which petitioner created in February, 1932: It is clear that there was not at that time a completed gift of the life income to petitioner's wife Alida. Under the original provisions of the trust indenture, this life estate was subject to revocation by the donor in conjunction either with the donor's half brother Ridgely or his mother Johnanna, neither of whose interests in the trust were adverse to the withdrawal of the life estate from Alida.

When the trust instrument was amended on December 11, 1937, so as to transfer to Alida alone the veto power over any further proposals by the donor for amendment of the trust, there was on that date a completed gift to Alida of the interest which she then held in the trust. It is stipulated that the value on December 11, 1937, of the income of a trust having a principal value of $518,089.76, payable during life of a woman of 29 (Alida's age), was $356,492.38. However, it is to be noted that Alida did not at this time hold an absolutely unqualified life interest in the income. By prior amendment, the indenture provided that the income of the trust was to be payable to Alida, wife of the donor, only "as long as she, during his lifetime, shall continue to be his wife and to reside with him." Whether, in the valuation of the gift to Alida on December 11, 1937, some allowance should be made for this qualification upon the life estate, we do not undertake to say. *Cf. Robinette* v. *Helvering*, 1943, 318 U.S. 184, 188. The Tax Court was in error, we think in ruling that upon the execution of the amendment of December 11, 1937, petitioner made a taxable gift of the whole corpus of the trust, valued then at $518,089.76. There were at that time no completed gifts to the succeeding income beneficiaries and beneficiaries in remainder, for Alida's interest in the trust was not adverse to the donor's revocation of those succeeding interests by an exercise of the reserved power.

By the amendment of June 6, 1946, whereby all power to revoke, alter or modify the trust was eliminated, there resulted a taxable gift of the then value

[2] This proposition is subject to qualification in the rather unusual situation like that presented by Trust No. 1 in *Commissioner* v. *Prouty*, C.A.1, 1940, 115 F.2d 331. There under the terms of the trust instrument, the grantor reserved a power to revoke or amend, with the written consent of her husband. Although the husband was not given the entire beneficial interest in the trust property, nevertheless he did have substantial interests, both in the disposition of the income and in the disposition of the corpus, which were adverse to any modification of the trust other than by way of augmenting the husband's interests. In these circumstances we held that there had been a completed gift of the entire corpus

of the corpus, minus the sum determined to be the value of the gift to Alida on December 11, 1937, and minus also the values of any completed gifts which may be deemed to have been made at the time of the creation of the trust on February 1, 1932. This latter point we do not have to determine in the present case, because petitioner's liability for the year 1946 is not before us. In passing, we simply allude to a possible difficulty, in that the donor originally reserved a power to revoke or modify the trust in conjunction with either Ridgely or Johnanna. Ridgely's contingent remainder interest might have been revoked by the donor, in conjunction with Johnanna, whose interest in the trust was not adverse to such revocation. Johnanna's contingent life estate could have been revoked by the donor in conjunction with Ridgely, whose interest in the trust was not adverse to such revocation. Where the veto power is thus lodged in the alternative, it may be that, for purpose of the gift tax, there is not a completed gift to either of such beneficiaries. But *cf. Estate of Leon N. Gillette*, 1946, 7 T.C. 219; *Commissioner* v. *Betts*, 7 Cir., 1941, 123 F.2d 534.

The decision of the Tax Court is vacated, and the case is remanded to that court for further proceedings not inconsistent with this opinion.

Note

1. Does a parent have a "substantial adverse interest" in a trust if his children are the beneficiaries? See *Commissioner* v. *Prouty*, 115 F.2d 331 (1st Cir. 1940):

> Another point was stressed by the Board of Tax Appeals in connection with Trusts Nos. 2 and 3, namely, that in each case the corpus at the death of Lewis, whose consent to change was required, was to go to his children. "It is natural to assume," said the Board, "that his desire and concern for the support, maintenance, and welfare of his children after his death would prompt him to resist any effort on the part of the grantor of the trust to alter, amend or revoke that part of the trust so as to revest in her title to such property" No doubt this is an interest of a sort. But we think the phrase "substantial adverse interest," as it was used in Section 501(c) of the Revenue Act of 1932 and as it is used in Sections 166 and 167 [1939 Code], means a direct legal or equitable interest in the trust property and not merely a sentimental or parental interest in seeing the trust fulfilled for the advantage of other beneficiaries. (*Loeb* v. *Commissioner*, 2 Cir., 113 F.2d 664, 666.)

What if the children were minors and were income beneficiaries of the trusts?

See *Latta* v. *Commissioner*, 212 F.2d 164 (3d Cir. 1954), cert. den. 345 U.S. 825, holding, one judge dissenting, that the settler's estranged husband did not have a substantial adverse interest in a trust, although their children were remaindermen.

See also *Joseloff* v. *Commissioner*, *supra*, p. 312.

2. The term "substantial adverse interest" was taken by the gift tax regulations from §501(c) of the Revenue Act of 1932, as the *Camp* case points out, and this statute took it from the statutory provisions governing the grantor's *income* tax liability on the income of a revocable trust. The common use of the term thus effected a degree of co-ordination between the gift tax and the income tax, *supra*, p. 315. In 1954, the term "substantial adverse interest" was dropped from the income tax provisions and the concept of "adverse" and "non-adverse" parties was substituted. An "adverse party" is defined by §672(a) as a person "having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." Apparently no substantive change in the law was intended. S. Rept. p. 365.

3. If the settlor's wife had consented to a modification of the trust that reduced the value of her life interest, would her action constitute a taxable gift by her? See *Cerf* v. *Commissioner*, 141 F.2d 564 (1st Cir. 1944).

4. If no gift tax is due when the grantor reserves the power to revoke with the consent of a non-beneficiary, should there be a tax when the latter can act alone? *Higgins* v. *Commissioner*, 129 F.2d 237 (1st Cir. 1942), cert. den 317 U.S. 658; *Herzog* v. *Commissioner*, 116 F.2d 591 (2d Cir. 1941).

3. Where the Decedent's Power Is to Modify a Transfer Made by Another

NEWBERRY'S ESTATE v. COMMISSIONER

U.S. Court of Appeals, Third Circuit, 1953
201 F.2d 874

Before GOODRICH, KALODNER and HASTIE, Circuit Judges.

HASTIE, Circuit Judge.

In these petitions for review the taxpayers complain that the Tax Court has improperly applied to the estate of Myrtle H. Newberry, deceased, the provisions of Section 811(d)(2) [§2038(a)(2), 1954 Code], that the gross estate shall include any property interest which decedent may have transferred in trust, where at the time of his death, the enjoyment of that interest was subject to change through exercise by the decedent of a power to alter or revoke. It is admitted that the trusts in controversy gave the decedent until her death such power of alteration. But they were created by transfer of her husband's property under a trust indenture executed solely by him. Nevertheless, the Tax Court, upholding the Commissioner of Internal Revenue, has ruled that in the particular circumstances of this case the decedent may properly be regarded and taxed as the transferor of the trust property within the meaning of Section 811(d)(2). 17 T.C. 597.

In 1934 both John J. Newberry and his wife, Myrtle H. Newberry, were independently wealthy. Among other holdings, each owned about 50,000 shares of J J. Newberry Company common stock, then valued at more than $50 per share. The Newberrys were deeply concerned for the future well being of their young children, a son and a daughter, neither of whom had independent means. In 1934 John Newberry created an irrevocable trust of 2500 shares of J. J Newberry Company common stock for his daughter and a like trust for his son. In 1935 he repeated the process. In each trust he named himself and his wife as trustees and gave Mrs. Newberry alone broad power to alter, amend or terminate the trust, but in no event to revest principal or income in him. Before Mrs. Newberry's death in 1944, this power had been so limited by amendment of each instrument that no more could be done in its exercise than to shift interests among the Newberry issue, spouses of such issue and charities. Other amendments of the trusts were made from time to time but their provisions have no bearing upon this case.

On each occasion when Mr. Newberry executed one of these trusts Mrs. Newberry similarly executed a trust placing 2500 of her shares of J. J. Newberry Company common stock in trust for the same child. In each case she named herself and her husband as trustees and gave him the same powers of alteration as she

was granted in the trusts created by him. Each time the husband amended the trusts he had created the wife made identical or equivalent changes in those she had created.

The Tax Court, in its findings of fact, had this to say about the circumstances under which these trusts were established:

> The idea of creating these trusts was first suggested to John J. Newberry by his brother, his business associate. After discussing the matter with his brother, John J. Newberry called in his attorney, with whom he discussed a plan that his brother had suggested. After John J. Newberry had the idea of creating the trusts "pretty well" fixed in his mind and shortly after he had first discussed it with his attorney he discussed it with his wife. He and she usually talked over matters as important as the trusts. They always handled the affairs of the family mutually. When decedent joined her husband and the attorney in the discussion she said that ". . . if it was a good thing to create these trusts, if John thought it was a good thing to create these trusts for the children, she did, too. She thought it was an excellent idea, and she wanted to do the same thing. She wanted to create the same type of trusts."
>
> He suggested the trust idea to her; she was interested right away and thought it was a good plan. Her purpose in creating her two 1935 trusts was the same as his. The decedent never gave any indication that she might not possibly execute the trusts. . . .
>
> The Newberry children at the time of the creation of the trusts in 1934 and 1935 had no independent means of their own. They were very young and the decedent and her husband did not know what kind of lifemates they might choose. They had a great interest in the children and wished to protect their interest.

In addition, Mr. Newberry was positive in his testimony, and it was in no way rebutted, that he would have created his trusts regardless of whether Mrs. Newberry had decided upon a similar course. He also testified that the property placed in trust represented a small fraction of the wealth of each spouse and that neither of them contemplated any personal benefit or gain from corpus or income of any of the trusts.[1] Mr. Newberry testified further and the Tax Court found that powers to shift beneficial interests were incorporated in the trust indentures so as to make sure that no "schemers or ne'er-do-wells" should obtain control of the property in the unhappy event of an unfortunate marriage by either of the children for whose security the trusts were designed.

On this showing the Tax Court reached ultimate factual conclusions that in establishing, and from time to time amending, these trusts "the decedent and her husband were acting as a unit . . . and that the trust instruments were merely part of an interdependent arrangement whereby neither decedent nor her husband would lose control of the amount of the J. J. Newberry Company stock transferred to the trusts until they saw fit to do so." On this basis, the Tax Court ruled that Mrs. Newberry should be regarded as the settlor of the trusts created by her husband as well as the holder of a power to change the enjoyment of the trust estate. Accordingly, the court treated the property in question as part of

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[1] These were New Jersey trusts. Whether the trustee could have employed his power to shift beneficial interests for his own advantage is as a matter of law at least doubtful. See In re Bender's Estate, 1937, 122 N.J Eq. 192, 197, 192 A. 718, 721, affirmed, 1938, 123 N.J.Eq. 171, 196 A. 677; In re Kline, 1948, 142 N.J.Eq. 20, 59 A.2d 14. In any event it seems clear on the record that no such use of the power was intended or contemplated when the trusts were established. And it is agreed that amendments prior to decedent's death precluded any such use of the power.

decedent's gross estate under the requirement of Section 811(d)(2) that the gross estate include any interests in property over "which the decedent has at any time made a transfer, by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke. . . ."

This case decides the taxable status of the trusts in terms created by Mr. Newberry and those only. The narrow question is whether the Tax Court erred in treating Mrs. Newberry as the person who had "made a transfer" of this property in trust within the meaning of Section 811(d)(2).

Normally taxing authorities and courts administering or applying a statute which taxes to a transferor's estate property he has transferred in trust reserving certain powers to himself have no occasion to go beyond the trust instrument in order to identify the transferor. At times, however, they have gone further. This procedure has been justified as necessary and proper to determine whether the significant shifting of economic interests and the change of dominion and control over property has been different from what the trust instrument itself indicates. And if such analysis shows that another than the formal settlor is in reality the transferor, his estate may be taxed accordingly.

The most obviously appropriate occasion for the application of the principle would be presented by a transaction in which one of the formal parties had been essentially a "straw" acting for someone else. Tax consequences, like many other legal and economic consequences of such a transaction, would attach to the real party in interest. A like result is clearly proper where, pursuant to a bargain and exchange, one party has given value to another to induce, and in consideration for, the creation of a trust by the second party wherein disposition is made of some beneficial interest as desired by the first party. Indeed, the taxing authorities need do no more than apply considered and accepted doctrine of the law of trusts to reach the conclusion that he who pays another for the creation of a trust wherein the payor shall be granted a beneficial interest or a power which he desires may be taxed as one who has transferred property retaining an interest therein. This doctrine has been recognized and applied in a line of cases beginning with *Lehman* v. *Commissioner of Internal Revenue*, 2 Cir., 1940, 109 F.2d 99.[2] That leading case clearly turned upon the court's reasoning that "the transfer by the decedent's brother, having been paid for and brought about by the decedent, was in substance a 'transfer' by the decedent, and property so transferred formed part of his taxable estate by virtue of [the statutory predecessor of §811(d)(2)], to the extent that the decedent had power to 'alter, amend or revoke' the enjoyment of it." 109 F.2d at pages 100-101.

It was also a fact in the *Lehman* case that the way the decedent, who was treated as transferor, had paid his brother for setting up the trust in question had been by setting up a similar trust conferring an equivalent benefit upon his brother. Thus, procedurally, the establishment of "reciprocal" or "crossed" trusts was a technical device for realizing the quid pro quo of a bargain.

[2] Followed in Hanauer's Estate v. Commissioner, 2 Cir., 1945, 149 F.2d 857, Cole's Estate v Commissioner, 8 Cir., 1944, 140 F.2d 636, 151 A.L.R. 1139; Commissioner of Internal Revenue v. Warner, 9 Cir., 1942, 127 F.2d 913.

The foregoing analysis is important because some of the subsequent cases which apply the *Lehman* doctrine have stressed the fact that trusts contained "reciprocal" or "crossed" provisions without spelling out that this circumstance is significant only to the extent that it may reveal a quid pro quo which another than the named grantor has paid for the creation of the trust in controversy. Actually, some of the cases seemed to go rather far in inferring such payment or consideration in connection with reciprocal or crossed provisions.[3] But this court in *In re Lueders' Estate*, 3 Cir., 1947, 164 F.2d 128, has taken the lead in indicating that payment for the creation of a trust by another must be real if the alleged payor rather than the apparent settlor is to be treated as grantor of the trust.[4] The essential picture which the crossed trusts must reveal to justify the result reached by the Tax Court in the present case is a declared grantor induced to establish a trust giving the party now to be treated for tax purposes as the grantor, a power which the latter has wanted and has paid for by setting up another trust to accomplish something desired by the declared grantor. Such in our view are the rather strict confines of the *Lehman* doctrine.

What the Tax Court found in this case, and what happened, if the undisputed testimony is to be believed, falls short of the foregoing requirements. The "unity" of action of husband and wife and the "interdependent" character of their transactions which the Tax Court found are not such circumstances as the *Lehman* doctrine comprehends. Spouses in mutual confidence and common interest work out together what each is going to do with his own money to provide for their children. In the normal case, which this appears to be, it is a distortion of meaning to say that the action of one spouse is a quid pro quo inducing the action of the other. The only "consideration" is the historic "consideration of love and affection" for the dependent members of one's family. Similarity of action occurs because each spouse is confident that they together have arrived at a wise and benevolent decision concerning the future welfare of their children. That is all there is to the "unity" and "interdependence" of action revealed by such a record as we have here. Neither the substance of the transaction nor the identity of the actor is revealed as any different from what appears on the face of each trust indenture.

We have also considered that in the present decision and one or two others,[5] the Tax Court may well be treating as special cases to be governed by rules of construction peculiar to them family trusts so created that husband and wife by separately granting each other powers over the enjoyment of trust property achieve essentially the same controls as would have resulted from reserving powers. Undoubtedly, in this connection as in others, domestic privacy and informality may effectively conceal understandings made and honored between husband and wife at variance with the formal and apparent aspects of family

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[3] *E.g.* Orvis v. Higgins, 2 Cir, 1950, 180 F 2d 537; Cole's Estate v. Commissioner, *supra*, note 2; Carrie S. Newberry, 1947, 6 T.C.M. 455, affirmed *per curiam*, 3 Cir., 1943, 172 F.2d 220, Eckhardt's Estate, 1945, 5 T.C. 673.

[4] The same approach and emphasis led the Tax Court to the same result where a third person had induced settlors separately to establish crossed trusts, one settlor not being advised what the other was doing. Samuel S. Lindsay's Estate, 1943, 2 T.C. 174.

[5] Particularly Werner A. Wieboldt, 1945, 5 T.C. 946; Carrie S. Newberry, *supra*, note 3.

financial transactions. A bargain and exchange, within the meaning of the *Lehman* doctrine may exist, yet be unprovable. Moreover, regardless of any such bargain, there may be policy considerations favorable to legislation which for particular tax purposes would treat these crossed trusts of spouses like a single joint transaction with both spouses pro tanto transferors of the property over which each will thereafter have certain control. But, absent such legislation, when on the facts the conclusion is inescapable that each spouse by a distinct and bona fide transaction has dispensed of his own separate estate in accordance with his own personal desires and without receiving a quid pro quo from the other, we think a court cannot justifiably refuse to recognize each spouse as the real transferor of the trust he has formally created.

In the present case Mr. Newberry himself executed an operative indenture to transfer his own property in trust for the benefit of his children, pursuant to his personal desire to provide for their security. Of course, the total result of this transaction and the companion transaction of Mrs. Newberry, with each spouse granting a power to the other, could have been achieved by each spouse reserving a power in the trust he created. We have no doubt that the parties, advised by counsel, deliberately chose the alternative which appeared to entail the less burdensome tax consequences. But tax saving motivation does not justify the taxing authorities or the courts in nullifying, or disregarding, the taxpayer's otherwise proper and bona fide choice among courses of action.

Finally, the Tax Court approved a deduction of $25,000 from the gross estate in anticipation of expenses of apportionment proceedings which its decision would necessitate. There will no longer be occasion for such proceedings or for the deduction.

The decisions of the Tax Court will be reversed and the cases remanded for the entry of dispositive orders consistent with this opinion.

Note

1. In *Estate of Hill* v. *Commissioner*, 23 T.C. 588 (1954), transfers in the form of reciprocal trusts were held made in contemplation of death because the complicated form was employed to avoid estate taxation. By reason of a later judicial construction of the statute, had the transfers been made in the normal manner, estate taxes would not have been due!

2. If the transfers are held to be reciprocal, troublesome gift tax questions may arise. See *Commissioner* v. *McLean*, 127 F.2d 942 (5th Cir. 1942); *Commissioner* v. *Warner*, 127 F.2d 913 (9th Cir. 1942); §1000(g), 1939 Code.

3. See generally Colgan and Molloy, "Converse Trusts—The Rise and Fall of a Tax Avoidance Device," 3 *Tax L. Rev.* 271 (1948).

FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX

Joint Study of Advisory Committee to Treasury Department and Office of Tax Legislative Counsel, 1947, pp. 18–21

It is proposed under this heading that a transfer shall be deemed incomplete and therefore not subject to transfer tax if the transferor, any other person, or

both retain a power of revocation, alteration, amendment, or termination enabling a change in the beneficial disposition of the property or the income therefrom. The transfer is rendered complete when all such authority finally comes to an end. If the power ceases during life, the transfer tax is incurred in the calendar year in which such cessation occurs. But if the power is outstanding at the transferor's death, the transferred property is treated as part of his taxable estate at death. A power held solely by another person, however, does not render a transfer incomplete if such person is authorized to vest the property in himself as well as others. In a similar connection, a power to change the beneficial disposition of the property does not postpone the completion of the transfer if such power is exercisable solely by will by a person other than the transferor. Finally, a transfer is deemed complete even though the transferor or others have power (*a*) to distribute or apply income to or for a current income beneficiary or to accumulate it for him, (*b*) to apply principal to or for the benefit of the income beneficiary of such portion; or (*c*) to effect a combination of these results.

The precise scope of the foregoing recommendation may be more easily appraised by comparing it with the existing gift- and estate-tax rules. At present a transfer is incomplete for gift-tax purposes if the transferor, either alone or in conjunction with a person lacking a substantial adverse interest, is empowered to revoke the transfer, to designate new beneficiaries, or to alter the relative interests of the named beneficiaries. See Reg. 108, section 86.3, *Burnet* v. *Guggenheim*, 288 U.S. 280 (1933); *Estate of Sanford* v. *Comm.*, 308 U.S. 39 (1939). On the other hand, if such a power over beneficial enjoyment is held by the transferor in conjunction with a person having a substantial interest adverse to another disposition, or is held solely by a person other than the transferor, the transfer constitutes a completed gift. See *Comm.* v. *Prouty*, 115 F.(2) 331 (C.C.A. 1st, 1940); *Higgins* v. *Comm.*, 129 F(2d) 237, 242 (C.C.A.1st, 1942) *cert. den.* 317 U.S. 658 (1942). Insofar as the estate tax is concerned, a transfer is taxable at death if the transferor alone or in conjunction with any person is authorized to change the enjoyment of the property through the exercise of a power to alter, amend, revoke or terminate. If the power is held solely by a person other than the transferor, the property subject to the power is not includible in the transferor's gross estate, unless a power to revest the property in him is exercisable in accordance with some standard enforceable in a court of equity, and not as the donee may freely determine. Compare *Blunt* v. *Kelly*, 131 F.(2d) 632 (C.C.A.3d, 1942), with *Comm.* v. *Irving Trust Co.*, 147 F.(2d), 946 (C.C.A.2d, 1945). *Cf.* the somewhat intermediate position in *Bankers Trust Co.* v. *Higgins*, 136 F.(2d) 477 (C.C.A.2d, 1943).

If the gift tax rules are placed alongside those proposed under the integrated transfer tax, it is evident that the line in certain instances has been moved over so that transfers which would now be deemed completed gifts would be considered incomplete under the proposed transfer tax. This shift is caused primarily by two factors. First, the proposed revision drops the substantial adverse interest concept which is not a significant element in the determination of gift tax liability, inasmuch as this concept is not responsive to the actual controls retained by a transferor through familial and financial ties. Since the substantial adverse interest concept was eliminated from the estate tax law in 1924, the proposed transfer tax

and the estate tax are thus identical in their treatment of a power held by the transferor alone or in conjunction with any other person.

Secondly, the proposed revision eliminates the distinction between a power held by the transferor in conjunction with another person and a power held solely by the other person. The present distinction assumes that a transferor exerts more influence upon another person as co-holder of a power rather than as transferor. As Congress has recognized since 1932 in connection with the income tax, however, any such distinction is unjustifiable and is self-defeating if avoidance is to be justly dealt with. See Sen. Rep. No. 665, 72d Cong., 1st Sess., (1932) 34, 35; Conf. Rep. No. 1492, 72d Cong., 1st Sess. (1932) 34, 35; Conf. Rep. No. 1492, 72d Cong., 1st Sess. (1932) 16. Accordingly, where the power to change the beneficial disposition of the property resides solely in a person other than the transferor, the integrated transfer tax seeks to establish a clear-cut rule that such a power postpones the completion of the transfer until death unless the power is relinquished at an earlier date.

The validity of the recommended rule seems beyond all reasonable doubt in view of *Helvering* v. *City Bank Farmers Trust Company*, 296 U.S. 85 (1935). According to this decision, Congress may regard a transfer as incomplete if the transferor retains a power to revise his disposition in conjunction with another person, including a beneficiary. Congress is free to assume that a beneficiary "of the grantor's immediate family might be amenable to persuasion" and that a grantor who desires to retain full dominion over the property will join with him in the exercise of his power someone who he believes "would comply with his wishes" *Id.* at p. 90. Although the *City Bank* decision dealt with a power of which the transferor was a formal co-holder, its rationale is not predicated upon this technical factor. If amenability to the transferor's persuasion is the dominant criterion, amenability is little affected by presence or absence of the transferor as a co-holder of the power. It is the ability to exert control and the creation of means for doing so which are determinative.

While continued dominion and control may be manifested through others, a point is reached where it is fair to conclude that they have generally come to an end. Hence it is provided that if a person other than the transferor is free to vest the property in himself, the transfer is complete. Such a transfer is not appreciably different from one which directly vests outright ownership in the other person. It is further provided that if a power in another person to change the beneficial enjoyment of the property may be exercised only by will, the transfer is equally complete. Admittedly, a donee of a testamentary power may be amenable to persuasion to such an extent that he will revest the property in the transferor or his estate. But such a power, when held by another, is not, as a rule, a ready means of assuring a continuing dominion in the transferor. In addition, the attribution of another person's testamentary power to the transferor would severely cripple the taxability of powers of appointment which are deemed the equivalent of ownership in the donee for tax purposes.

The recommendation also provides that certain powers, which allow for a limited type of shifting in beneficial enjoyment, shall not render the transfer incomplete. Thus, the transferor will be required to pay a transfer tax at the time of transfer, and will thereafter be relieved from tax on the income from

the transferred property, where he or another person has the power to distribute income to or for the benefit of a current income beneficiary or to accumulate it for future distribution to him. . . . [I]t is true that if distribution of income is withheld and the current income beneficiary of a trust dies prior to the expiration of the trust, the accumulations may ultimately pass to an alternate taker. Such a power of accumulation, however, is very limited in scope since its operation as a method of adjusting beneficial enjoyment depends upon the untimely death of the current income beneficiary. It is also provided that a transfer shall be deemed complete despite a power in the transferor or another person to pay over any portion of the principal to the current income beneficiary of such portion. Such a power of invasion undoubtedly permits continuation of dominion over the transferred property. It is believed, however, that transferors should not be entirely precluded from attempting to meet the needs of changing circumstances, such as a sudden emergency which requires immediate invasion of principal to assist the current income beneficiary. This consideration, it is felt, warrants the creation of a distinction between a limited power to invade and other powers to shift beneficial enjoyment.

Note

For other proposals looking toward a coordination of the income, estate and gift taxes on *inter vivos* transfers, see American Law Institute, *Federal Income, Estate and Gift Tax Statute* (Tentative Draft No. 10, 1955) 175–216.

Section D. Transfers with Retained Life Estate: Section 2036

Internal Revenue Code of 1954

Sec. 2036. Transfers with Retained Life Estate.

(a) General Rule.—The value of the gross estate shall include the value of all property (except real property situated outside of the United States) to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

(b) Limitation on Application of General Rule.—This section shall not apply to a transfer made before March 4, 1931, nor to a transfer made after March 3, 1931, and before June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

From the time of its original enactment in 1916, until the Internal Revenue Code was revised in 1954, the federal estate tax reached transfers "intended to take effect in possession or enjoyment at or after [the transferor's] death." It has already been noted (*supra*, p. 1061) that from 1916 to 1924 revocable trusts were

included in the gross estate by virtue of this statutory provision, and that in 1924 the predecessor of §2038 was enacted to deal explicitly with transfers under which the transferor retained the right to alter, amend or revoke. Thereafter, despite an overlapping area, the taxability of transfers of this type was primarily governed by the explicit statutory language of §2038 as modified from time to time, rather than by the more vague standard of the "possession or enjoyment" clause. The scope of §2038 was studied in Section C of this chapter.

A second type of transfer that was originally tested by the "possession or enjoyment" clause was the gift of property with a reservation by the donor of the right to receive or to control the income. In 1931, however, this type of disposition also received explicit statutory recognition. The governing statute is now §2036.

A third type of transfer that was formerly subject to the "possession or enjoyment" clause was a gift of property that might revert to the transferor's estate at or after his death The statute was amended in time to deal specifically with this type of transfer too, but this did not occur until 1949. The current version of the 1949 legislation is §2037.

In Sections D and E of this chapter, we will examine the fashion in which §2036 (transfers with retained life estates) and §2037 (transfers taking effect at death) developed out of the more primitive "possession or enjoyment" clause.

The growth of a progressively more elaborate statute culminated, in 1954, in the elimination of the "possession or enjoyment" clause.* But the current provisions can hardly be understood without a few words of history.

In 1916, when the postponed-possession-or-enjoyment clause was enacted, it was apparently generally believed that it brought into the gross estate property that had been transferred by the decedent during his lifetime if he reserved to himself the income from the property. The pre-1916 understanding of the clause has been described by the Supreme Court in *Commissioner* v. *Estate of Church*, 335 U.S. 632 (1949), as follows.

> The "possession or enjoyment" provision . . . seems to have originated in a Pennsylvania inheritance tax law in 1826.[1] As early as 1884 the Supreme Court of Pennsylvania held that where a legal transfer of property was made which carried with it a right of possession with a reservation by the grantor of income and profits from the property for his life, the transfer was not intended to take effect in enjoyment until the grantor's death "One certainly cannot be considered, as in the actual enjoyment of an estate, who has no right to the profits or incomes arising or accruing there-

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* In 1942, Paul complained "We have been like Englishmen who never clean their slates; no language could be thrown away if anyone thought in optimistic vein that he understood its meaning. Amendments consisted of addition, duplication and overlapping. No one suggested the heroic remedy of fresh language which would clear away the debris and say simply what was plainly dictated by disillusioning experience with a statute that had repeatedly failed to say what the Treasury, at least, thought it meant. It was easier to repair at damaged points in a makeshift way, always hoping for a dim best Some day we shall learn that sound revenue laws are not made in such a piecemeal way, and that postponing such important tax problems may be an expensive luxury." Paul, *Federal Estate and Gift Taxation* (1942) Sec. 7 01. In the years that have followed Mr. Paul's complaint, the process of shoring up, rather than rebuilding, the structure has continued, and even the 1954 elimination of the "possession or enjoyment" clause falls short of the "heroic remedy of fresh language" that he urged.

[1] Leighton, "Origin of the Phrase, 'Intended To Take Effect in Possession or Enjoyment At or After . . . Death' (§811(c), Internal Revenue Code)," 56 *Yale L. J.* 176 (1946).

from." Reish, *Adm'r* v. *Commonwealth*, 106 Pa. 521, 526. That court further held that the "possession or enjoyment" clause did not involve a mere technical question of title, but that the law imposed the death tax unless one had parted during his life with his possession and his title and his enjoyment. It was further held in that case that the test of "intended" was not a subjective one, that the question was not what the parties intended to do, but what the transaction actually effected as to title, possession and enjoyment.

Most of the states have included the Pennsylvania-originated "possession or enjoyment" clause in death tax statutes, and with what appears to be complete unanimity, they have up to this day [1949] substantially agreed with this 1884 Pennsylvania Supreme Court interpretation[2] Congress used the "possession or enjoyment" clause in death tax legislation in 1862, 1864, and 1898. 12 Stat. 432, 485, 13 Stat. 232, 285, 30 Stat. 448, 464. In referring to the provision in the 1898 Act, this Court said that it made "the liability for taxation depend, not upon the mere vesting in a technical sense of title to the gift, but upon the actual possession or enjoyment thereof" *Vanderbilt* v *Eidman*, 196 U.S. 480, 493. And five years before the 1916 estate tax statute incorporated the "possession or enjoyment" clause to frustrate estate tax evasions, 39 Stat 756, 780, this Court had affirmed a judgment of the New York Court of Appeals sustaining the constitutionality of its state inheritance tax in an opinion which said "It is true that an ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate." *Matter of Keeney*, 194 N.Y 281, 287; *Keeney* v. *New York*, 222 U.S. 525. (335 U.S. at 637-8.)

See also *Vanderlip* v. *Commissioner*, 155 F.2d 152 (2d Cir. 1946), cert. den. 329 U.S. 728, where Judge L. Hand said that such a transfer "is as nearly the substitute for a bequest as it can be and still remain a gift at all," hinting that the reservation of income from transferred property might *ipso facto* stamp the transfer as a gift in contemplation of death.

Treasury practice from 1916 to 1930 accorded with the interpretation of the postponed-possession-or-enjoyment clause described above. *Commissioner* v. *Estate of Church*, *supra*, at 639.

In 1930, however, the Supreme Court rejected this construction of the clause in *May* v. *Heiner*, 281 U.S. 238 (1930). The decedent in this case had transferred property in trust in 1917 to pay the income to her husband for his life and to her for her life if she survived him; upon her death, the trust was to terminate and the property was to be distributed to her childeren. The record did not disclose whether she had survived her husband, so as to come into present enjoyment of the income, or not; but the Court thought this was not relevant. Holding that the trust property was not part of the decedent-settlor's gross estate, the Court said:

[The transfer in 1917] was not testamentary in character and was beyond recall by the decedent. At the death of Mrs. May no interest in the property held under the trust deed passed from her to the living, title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death was obliterated by that event.

After *May* v. *Heiner* was decided, there remained for the Treasury the hope

[2] See cases collected in 49 A.L.R. 878-892; 67 A L R. 1250-1254, 100 A L R. 1246-1254. See also Rottschaefer, Taxation of Transfers Taking Effect in Possession at Grantor's Death, 26 *Iowa L. Rev.* 514 (1941); Oliver, Property Rationalism and Tax Pragmatism, 20 *Tex. L. Rev.* 675, 704-709 (1942).

that it could be confined to its own peculiar facts. the decedent had retained a contingent, or secondary, life estate, rather than a primary one. The next year, this hope was dashed when the Supreme Court decided *Burnet* v. *Northern Trust Co.*, 283 U.S. 782 (1931), involving a trust under which the settlor retained a life interest in the income, without the intervention of an intermediate life tenant. The Court said, *per curiam:*

> The question in this case is that of the construction of §402(c) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 278, a provision similar to that of §402(c) of the Revenue Act of 1918, c. 18, 40 Stat 1057, 1097, which has already been construed by this Court, and, in this view, there being no question of the constitutional authority of the Congress to impose prospectively a tax with respect to transfers or trusts of the sort here involved, the judgment of the Circuit Court of Appeals for the Seventh Circuit is affirmed upon the authority of *May* v. *Heiner*. . . .

There was a dramatic climax to *Burnet* v. *Northern Trust Co.* and to two companion cases decided at the same time:

> March 3, 1931, the next day after the three *per curiam* opinions were rendered, Acting Secretary of the Treasury Ogden Mills wrote a letter to the Speaker of the House explaining the holdings in *May* v *Heiner* and the three cases decided the day before He pointed out the disastrous effects they would have on the estate tax law and urged that Congress "in order to prevent tax evasion," immediately "correct this situation" brought about by *May* v. *Heiner* and the other cases. 74 Cong. Rec. 7198, 7199 (1931). He expressed fear that without such action the Government would suffer "a loss in excess of one-third of the revenue derived from the federal estate tax, with anticipated refunds in excess of $25,000,000." The Secretary's surprise at the decisions and his apprehensions as to their tax evasion consequences were repeated on the floor of the House and Senate. 74 Cong. Rec. *supra.* Senator Smoot, Chairman of the Senate Finance Committee, said on the floor of the Senate that this judicial interpretation of the statute "came almost like a bombshell, because nobody ever anticipated such a decision." * 74 Cong. Rec. 7078. Both houses of Congress unanimously passed and the President signed the requested resolution that same day. (*Commissioner* v. *Estate of Church*, 335 U.S. at 639–40.)

Because Congress was scheduled to adjourn the following day, the resolution was adopted under a suspension of the rules and without having been printed, in reliance upon statements from the floor.

The Joint Resolution of March 3, 1931, enacted in such haste, provided for the inclusion in the gross estate of transferred property if the transferor retained for his life or any period not ending before his death (1) the possession or enjoyment of, or the income from, the property, or (2) the right to designate the persons who should possess or enjoy the property or the income therefrom. In 1932, this provision was amended so as to give it the form now found in §2036(a), *supra*, p. 1103. The 1932 amendment was explained by the House Committee on Ways and Means (H. Rept. No. 708, 72d Cong., 1st Sess., in 1939-1 C.B. (Part 2) pp. 490–91):

> The purpose of this amendment . . . is to clarify in certain respects the amendments made to that section by the joint resolution of March 3, 1931, which were adopted to render taxable a transfer under which the decedent reserved the income for his life.

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* It has been suggested that this is hyperbole. Pavenstedt, "Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel," 5 *Tax L. Rev.* 309, note 155 (1950).

The joint resolution was designed to avoid the effect of decisions of the Supreme Court holding such a transfer not taxable if irrevocable and not made in contemplation of death. Certain new matter has also been added, which is without retroactive effect.

The changes are:

(1) The insertion of the words "or for any period not ascertainable without reference to his death," is to reach, for example, a transfer where decedent reserved to himself semiannual payments of the income of a trust which he had established, but with the provision that no part of the trust income between the last semiannual payment to him and his death should be paid to him or his estate, or where he reserves the income, not necessarily for the remainder of his life, but for a period in the ascertainment of which the date of his death was a necessary element.

(2) The insertion of the words "or for any period which does not in fact end before his death," which is to reach, for example, a transfer where decedent, 70 years old, reserves the income for an extended term of years and dies during the term, or where he is to have the income from and after the death of another person until his own death, and such other person predeceases him. This is a clarifying change and does not represent new matter.

(3) The insertion of the words "the right to the income" in place of the words "the income" is designed to reach a case where decedent had the right to the income, though he did not actually receive it. This is also a clarifying change.

(4) The insertion of the words "either alone or in conjunction with any person" is to reach a case where decedent had a right, with the concurrence of another person or persons, to designate those who should possess or enjoy the property or the income therefrom.

Section 2036(b), it will be noted, provides that transfers made between March 3, 1931 and June 7, 1932, are to be governed by the Joint Resolution of March 3, 1931, rather than by the amended provision enacted in 1932.

Although the Supreme Court in *Burnet* v. *Northern Trust Co.* had taken the unusual step of advising that there was "no question of the constitutional authority of the Congress to impose prospectively a tax with respect to transfers of trusts of the sort here involved," the constitutionality of the Joint Resolution of March 3, 1931 was challenged by a taxpayer in *Helvering* v. *Bullard*, 303 U.S. 297 (1938). The Supreme Court did not retreat:

The contention is that the transfer was *inter vivos*, was presently effective, was irrevocable, was not made in contemplation of, or effective at, death, and that Congress was, therefore, without power to make it the subject of an estate or inheritance tax, that, while the transfer might, by appropriate legislation, have been taxed as a gift, to tax it as in the nature of a testamentary disposition is a denial of due process. The contention is unsound for several reasons. Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax. Moreover, Congress having the right to classify gifts of different sorts might impose an excise at one rate upon a gift without reservation of a life estate and at another rate upon a gift with such reservation. Such a classification would not be arbitrary or unreasonable. A further vindication of the exaction is the authority of Congress to treat as testamentary, transfers with reservation of a power or an interest in the donor. The legislative history of the Joint Resolution . . . demonstrates that the purpose of the legislation was to prevent avoidance of estate taxes. As has been said by the Court of Appeals of New York: "It is true that an ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate." [1]

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[1] In the Matter of Keeney, 194 N.Y. 281, 287; 87 N.E. 428; affirmed 222 U.S. 525.

We have recently sustained the prospective operation of a provision including in the gross estate property which a decedent has transferred retaining power alone, or in conjunction with any other person, to alter, amend, or revoke.[2] We held the purpose of the clause was to prevent avoidance of tax and the measure was reasonably calculated to that end. As applied to a trust created after its enactment the Joint Resolution does not violate the Fifth Amendment.

As the last sentence of the extract from the opinion in the *Bullard* case suggests, the case concerned a trust created after the enactment of the Joint Resolution. On the same day that the *Bullard* case was decided, the Supreme Court held that the Joint Resolution of March 3, 1931 and the 1932 amendment thereof were both intended by Congress to be prospective only. *Hassett* v. *Welch*, 303 U.S. 303 (1938).

For a few years after 1938, it seemed clear that pre-1931 transfers with retained life estates were immune from the federal estate tax. (If property was added after 1931 to a pre-1931 trust, however, the post-1931 additions were subject to estate tax, *Pearson* v. *Commissioner*, 36 B.T.A. 5 (1937); *Estate of Curie* v. *Commissioner*, 4 T.C. 1175, 1181–2 (1945).) But in 1940, the Supreme Court decided *Helvering* v. *Hallock*, *infra*, p. 1133, which, while it did not pass on the status of pre-1931 life estates, led some judges and commentators to believe that *May* v. *Heiner* had been repudiated by implication. In 1948, speculation increased when the Supreme Court ordered a reargument in *Commissioner* v. *Estate of Church*, involving a pre-1931 trust with retained life estate. The Treasury had originally contended that the trust was part of the decedent's gross estate, not because of the retained life estate, but because in its view the settlor possessed until his death a reversionary interest in the corpus,* and the case had been argued before the Supreme Court in 1947 on this theory. Reargument of this and another case was ordered in 1948, and counsel were "requested to discuss particularly" a number of questions, several of which were directed to the status of pre-1931 life estates. 68 S. Ct. 1522, 1524 (1947). On reargument, the Treasury again suggested that the *Church* case could be decided upon narrow grounds, without overruling *May* v. *Heiner*, but it also argued that that case should be explicitly overruled. The Court, by a divided vote, did so:

Crucial to the court's holding in *May* v. *Heiner* was its finding that no interest in the corpus passed at the settlor's death because legal title had passed from the settlor irrevocably when the trust was executed; for this reason the grantor's reservation of the trust income for his life—one of the chief bundle-of-ownership interests—was held not to bring the transfer within the category of transfers "intended to take effect in . . . enjoyment at . . . his death." This Court had never before so limited the possession or enjoyment section. Thus was formal legal title rather than the substance of a transaction made the sole test of taxability under §811(c) [1939 Code]. For from the viewpoint of the grantor the significant effect of this transaction was his continued enjoyment and retention of the income until his death, the important consequence to the remaindermen was the postponement of their right to this enjoyment of the income until the grantor's death.

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[2] Helvering v. City Bank Farmers T Co., 296 U.S. 85, 90. Compare Milliken v. United States, 283 U.S. 15, Tyler v. United States, 281 U S 497.

* The principles governing the estate tax status of reversionary interests will be examined *infra*, pp. 1129–45.

> The effect of the court's interpretation of this estate tax section was to permit a person to relieve his estate from the tax by conveying its legal title to trustees whom he selected, with an agreement that they manage the estate during his life, pay to him all income and profits from the property during his life, and deliver it to his chosen beneficiaries at death. Preparation of papers to defeat an estate tax thus became an easy chore for one skilled in the "various niceties of the art of conveyancing." *Klein* v. *United States*, 283 U.S. 231, 234. And by this simple method one could, despite the "possession or enjoyment" clause, retain and enjoy all the fruits of his property during life and direct its distribution at death, free from taxes that others less skilled in tax technique would have to pay. Regardless of these facts, *May* v. *Heiner* held that such an instrument preserving the beneficial use of one's property during life and providing for its distribution and delivery at death was "not testamentary in character"

There were forceful dissents by Justices Burton, Reed, and Frankfurter, resting primarily on the doctrine of *stare decisis* and on the theory that Congress had impliedly accepted *May* v. *Heiner* in 1931 and 1932 by overruling it only prospectively.

The *Church* case has not had a happy life. Eight months after it was decided, the Treasury Department issued new regulations, announcing that the case would be applied only to the estates of decedents dying after the date of the decision, presumably on the theory that settlors who died before the *Church* case was decided had relied on the vitality of *May* v. *Heiner* and would have surrendered their life estates had they anticipated that it would be overruled. A month later, Congress went further. It enacted the Technical Changes Act of 1949, overruling the *Church* case for settlors dying before January 1, 1950. Settlors still alive were allowed to release or assign their life estates free of gift tax without having the transfer treated as a gift in contemplation of death. Was such "relief" justified? See Bittker, "Church and Spiegel, The Legislative Sequel," 59 *Yale L.J.* 395, 414–418 (1950); Pavenstedt, "Congress Deactivates Another Bombshell. The Mitigation of Church and Spiegel," 5 *Tax L. Rev.* 309 (1950). The 1949 legislation was only the first step. By the Revenue Act of 1950, the terminal date set in the 1949 act was advanced to January 1, 1951. Finally, in 1953, Congress overruled the *Church* case as to all pre-1931 transfers, regardless of the date of the transferor's death, in response to a recommendation of the House Ways and Means Committee that "the effect of the Church decision should be eliminated in all cases to which it was applicable." H. Rept. No. 894, 83d Cong., 1st Sess., 53–2 C.B. 508, 513. The 1953 legislation is carried over as §2036(b) of the 1954 Code. It reflects a return, perhaps more than temporarily, to the status as of 1938, when it was held in *Hassett* v. *Welch* that the 1931 and 1932 legislation was prospective only, and when the rule of *May* v. *Heiner* controlled pre-1931 transfers.

COMMISSIONER v. DWIGHT'S ESTATE

U.S. Court of Appeals, Second Circuit, 1953
205 F.2d 298, cert. den. 346 U.S. 871

Before L. Hand, Augustus N. Hand and Frank, Circuit Judges.

Augustus N. Hand, Circuit Judge.

The Tax Court, with four judges dissenting, held that there is an overpayment of the estate tax in the amount of $173,353.28 since the Commissioner had erred

in including the decedent's gross estate the value of two trusts established by him during his lifetime. 17 T.C. 1317. The findings of fact by the Tax Court may be summarized as follows:

The decedent, Arthur S Dwight, who at the time of his death on April 1, 1946, was a resident of the State of New York, on March 15, 1930, married Anne Howard Chapin who had had six children by a previous marriage. All of the children were adults at that time with the exception of one who was seventeen years of age. Until decedent's death he and his wife lived together as husband and wife at their principal residence in Great Neck, Long Island, except for winters which were spent at their Florida home.

On December 21, 1931, the decedent established a trust of $170,000, which he increased by $25,000 in 1934, for the benefit of his wife and her six children. The corporate trustee was to distribute 40% of the income to the decedent's wife and 10% to each of her children "for their support and maintenance," but the trustee was "not responsible for the use or application of such income." The trust was to terminate at the death of the survivor of the decedent and his wife, when the principal was to be distributed to the children or their issue. Provision was made for the allocation of the income share of any beneficiary who died prior to the termination.

On August 15, 1935, the decedent made a transfer, on which a federal gift tax was assessed and paid, of $200,000 in trust. The trust indenture provided that the decedent's wife would receive the income during her lifetime "for her support and maintenance, without power of anticipation." Upon the death of the income-beneficiary the trust was to terminate and the principal was to be distributed in equal shares to eight named persons or their issue. A letter written before, but not delivered until after, the execution of the trust indenture shows that the decedent's motive for establishing this trust was to provide his wife with income to meet the living and hospital expenses of her two adult invalid daughters and to meet the annual maintenance expense of the winter home in Florida which he had previously given to her. At all times during their marriage the decedent paid the expenses of running the family home in Great Neck, Long Island; after the establishment of the first trust the decedent's wife paid for her own clothing and other personal needs.

The Commissioner contends that 40% of the value of the first trust, and the entire value of the second trust are includible in the decedent's gross estate by reason of the applicable provisions of the Internal Revenue Code [§2036, 1954 Code], since the income was to be used to discharge his legal obligation to support his wife.[1] (The Commissioner has conceded that New York law imposed no legal obligation upon the decedent to support his surviving stepchildren who

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[1] The applicable regulation, Treas. Reg. 105, §81.18, provides in part·

"The use, possession, right to the income, or other enjoyment of the property will be considered as having been retained by or reserved to the decedent to the extent that during any such period it is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.

"If such retention or reservation is of a part only of the use, possession, income, or other enjoyment of the property, then only a corresponding proportion of the value of the property should be included in determining the value of the gross estate."

were all adults at the time of his death, see *People ex rel. Deming* v. *Williams*, 161 Misc. 573, 577, 292 N.Y.S. 458, and therefore has limited the appeal to 40% of the value of the first trust. The wife's share of the income was increased by 4.45% on the death of one of her children prior to the termination of the trust, but because that income was received by operation of the dispositive provisions which were not based upon considerations of support the Commissioner has not argued that the proportion of the corpus to be included in the gross estate should be correspondingly increased.) The majority of the Tax Court held that the decedent did not retain the enjoyment of the income for life since he did not reserve to himself an enforceable right to have the trust income applied towards his wife's support.

Although a husband is of course able to make a gift to his wife without affecting his duty to support her, *Shanley* v. *Bowers*, 2 Cir., 81 F.2d 13, 15, we think that this was clearly not the case here as to the first trust. The decedent was under a legal duty to support his wife under the New York law, *e.g.*, *DeBrauwere* v. *DeBrauwere*, 203 N.Y. 460, 96 N.E. 722, 38 L.R.A., N.S., 508, and the trust instrument provided that the income was for her "support and maintenance." We agree with the dissenting opinion in the Tax Court that this provision was not meaningless, and think that *Helvering* v. *Mercantile-Commerce Bank & Trust Co.*, 8 Cir., 111 F.2d 224, certiorari denied 310 U.S. 654, 60 S. Ct. 1104, 84 L. Ed. 1418, is not distinguishable on the ground that there the settlor reserved an "enforceable right" to have the income applied toward his wife's support in the trust instrument. See also *Helfrich's Estate* v. *Commissioner*, 7 Cir., 143 F.2d 43; *Hooper* v. *Commissioner*, 41 B.T.A. 114. Having furnished his wife with this income the husband had in part at least discharged his legal obligation of supporting her. *Northeastern Real Estate Securities Corp.* v. *Goldstein*, 2 Cir., 163 F.2d 963; *Wanamaker* v. *Weaver*, 176 N.Y. 75, 82, 68 N.E. 135, 65 L.R.A. 529. The existence of the income from the trust would certainly have been a *pro tanto* defense in any suit for support brought by his wife. We do not see how the absence of a provision in the trust for rigid supervision of the wife's expenditures in any way affects this reasoning. Nor do we see why it should matter that the decedent's full obligation to support may not have been discharged, *Garlock* v. *Garlock*, 279 N.Y. 337, 18 N.E.2d 521, 120 A.L.R. 1331. Thus, since part of the income of the first trust was, in the language of the regulations, "to be applied toward the discharge of a legal obligation of the decedent," we hold that he retained the enjoyment of that income and accordingly 40% of the value of the trust is includible in his gross estate.

The second trust presents a more difficult problem. Although the trust instrument also provided that the income was to be paid for the "support and maintenance" of the decedent's wife, his explanatory letter indicates that his intent was to furnish her with sufficient income to care for her two invalid daughters and to pay for the maintenance of the Florida home. It is asserted that neither item was within the decedent's legal duty to provide for his wife, and that therefore he did not retain the enjoyment of the income within the meaning of §811(c)(1)(B). The taxpayer justifies the admission of this letter into evidence by the Tax Court over the objection of the Commissioner on the ground that the parol evidence rule is inapplicable in a controversy involving a stranger to

the integrated trust indenture. *Stern* v. *Commissioner*, 2 Cir., 137 F.2d 43, 46; *Brassert* v. *Clark*, 2 Cir., 162 F.2d 967, 973–974; *Folinsbee* v. *Sawyer*, 157 N.Y. 196, 199, 51 N.E. 994. However, this is too broad a statement of the rule, for a stranger to an instrument may not in every case vary its terms by parol evidence. *E. g.*, *Pugh* v. *Commissioner*, 5 Cir., 49 F.2d 76, 79, certiorari denied *Pugh* v. *Burnett*, 284 U.S. 642, 52 S. Ct. 22, 76 L. Ed. 546; *Funk* v. *Commissioner*, 3 Cir., 185 F.2d 127, 129 note 3; *Allen* v. *Ruland*, 79 Conn. 405, 65 A. 138. Facts recited in an integrated agreement may of course be shown to be untrue even by the parties themselves. *Restatement*, *Contracts*, §244. Moreover, proof of fraud against the rights of third parties may be received, even though such evidence would perhaps be inadmissible in a suit between the parties themselves. 3 Williston, *Contracts*, §647 (Rev. ed.); 9 Wigmore, *Evidence* §2446 (3d ed.). But here there is no question of fraud on the rights of the tax collector. And where the issue in dispute is the legal obligation of the parties to the agreement, the writing must be taken as the full expression of that legal relationship (assuming that the parties intended the writing to be an integration of the complete contract). 3 Corbin, *Contracts*, §596; 3 Williston, *Contracts*, §647 (Rev. ed.); 9 Wigmore, *Evidence*, §2446 (3d ed.).

The trust indenture here created a legal obligation on the part of the trustee to pay the income to the settlor's wife for her "support and maintenance." Although strictly speaking the wife was not a party to the agreement, it is to her that the obligation is owed and only she may enforce it. *Restatement*, *Trusts*, §200; 2 Scott, *Trusts*, §200. Her rights are entirely dependent on the legal effect of the trust indenture. Consequently, in a suit by the wife against her husband for support the parol evidence rule would have prevented her from showing that the income was not to be used for her "support and maintenance" and the existence of the second trust would have been a *pro tanto* defense for the husband. Therefore, since the income was to be used to discharge the decedent's legal obligation, he retained its enjoyment and use, and under §811(c)(1)(B) [§2036(a), 1954 Code] the principal of the trust is includible in his gross estate.

The respondent has presented no proof that the decedent's obligation to support would not have at least equalled the amount of the income payable to his wife from these two trusts. The taxpayer had the burden of proof upon this question, see, *e. g.*, *Welch* v. *Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212, and in the light of his evident wealth we hold that the decedent's own estimation in the provisions of these trusts of the extent of his obligation to provide for his wife did not exceed what the law would have required of him. Therefore, 40% of the value of the first trust, and the entire value of the second trust are includible in his gross estate.

Accordingly, the judgment is reversed and the case remanded to the Tax Court for a recomputation of the decedent's estate tax in accordance with the terms of this opinion.

L. Hand, Circuit Judge (dissenting in part).

I altogether agree as to the first trust, for it seems fair to me to hold the taxpayers to their burden of proof to show that forty per cent of its income would not have been more than a reasonable allowance to the wife for her "support and maintenance." As to the second trust, if we were to affirm the order, I think

I should also agree that the taxpayers should have shown that the income from it, when added to forty per cent of the income from the first trust, was no more than a New York court would have allowed to the decedent's wife for "support and maintenance." But we are reversing the order and are sending the cause back to the Tax Court to recompute the tax; and I do not see what warrant we have for denying to the taxpayers the privilege of carrying the burden of so proving, if they can, now that it has become vital. The only reason for such a denial must be that they failed to do so before, when it turned out to be unnecessary; and that appears to me unduly severe.

The liability of a husband for the "support and maintenance" of his wife depends, certainly in cases of divorce, upon his resources and the spouses' customary mode of life. Only to that extent is he liable, and his liability measures the extent of the tax in the case at bar. It is a very fluid issue at best, and if the taxpayers wish to contest it, I would not foreclose them. I agree that in an action on the deed the husband's letter could not be used to modify the obligation to devote the income of the second trust to the wife's "support and maintenance"; but what he gave does not measure what the courts would allow her; and the letter would certainly be competent evidence of his opinion as to what was a suitable allowance. Moreover, I rather think that his opinion would be relevant in determining the amount of his legal liability for "support and maintenance," though that is not so plain. In any event, I need not pass on that, for my view is not to prevail.

Note

1. See *Estate of Sherman* v. *Commissioner*, 9 T.C. 594 (1947), noted, 48 *Col. L. Rev.* 293 (1948). Note that the regulations employ the phrase "to the extent that . . . it [income] is to be applied towards the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit." Regs. 105, Sec. 81.18. See §677(b), providing that the income of a "support" trust is not to be taxed as income of the grantor "merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed." This provision was enacted after it was held in *Helvering* v. *Stuart*, 317 U.S 154 (1942), that if a trustee had the power to use the income of a trust for the support of the grantor's minor children, the income came within the language of what is now §677(a)(1) and (2). *Supra*, p. 315. May a support trust be included in the gross estate even though the income was not taxed to the decedent during his lifetime, or be excluded from the estate even though the income was taxed to the decedent? *Should* different tests be applied?

2. There was no gift tax when the 1931 trust was created. Had it been created after 1931, would a federal gift tax be due? Gift tax was paid, the court states, on the 1935 trust. Should the value of the wife's income interest have been excluded in computing the grantor's gift tax liability?

3. See §682, providing that a wife who is divorced or legally separated from her husband must report the income of a trust created by the husband for her support. Is the corpus of such a trust includible in the husband's gross estate, even though the wife is taxable on the income, under §2036(a)(1)? Can it be excluded from the husband's estate under the parenthetical clause relating to a bona fide sale? *Supra*, p. 1103.

4. *Estate of Boardman* v. *Commissioner*, 20 T.C. 871 (1953), involved a transfer of property in trust under which the trustees were to make such distributions to the grantor from income and principal as they "deem necessary for her comfort, support

and/or happiness." The court found that the trust instrument "offered no basis upon which the trustees could have withheld any of the income of the trust which the decedent might have desired during her life" and held that in these circumstances she retained the right to the income for life. The principal purpose of the trust was to support the decedent, the court said that the trustees "could not resist her demand for the income," and she in fact did receive the income therefrom during her life. Would the result have been different if the primary purpose of the trust had been to provide an income for life for the grantor's parents, but the trustees were given the power to make such distributions to the grantor as they "deem necessary for her comfort, support and/or happiness"?

MARKS v. HIGGINS

U. S. Court of Appeals, Second Circuit, 1954
213 F.2d 884

The facts are stated by the trial judge as follows:

This is a suit for the recovery of a payment of Estate Tax. . . . The plaintiffs are executors of one Louis B Marks who died November 22, 1939, a resident of New York City. On December 1, 1935 decedent conveyed a certain parcel of real estate and two mortgages to his wife, his son and himself as trustees, to pay the net income to his wife for her life and to himself thereafter for his life if he survived his wife and, upon the death of the survivor of the two, to distribute it in accordance with other clauses in the trust instrument. The instrument further provided that if, when the time for distribution arrived, there would not be surviving any of his sons or their issue, then the principal was to be distributed in like manner as the will of his wife would provide for the distribution of her residuary estate. A gift tax was duly paid on the trust corpus and no claim for refund was ever filed. Decedent predeceased his wife. The Commissioner included in the decedent's estate the value of the remainder interest in the corpus following the life interest of decedent's wife. The tax and an additional deficiency were paid and the claim and amended claim for refund were filed. The claims for refund were rejected by letter of the Commissioner in which he determined that the remainder interest constituted an interest of which decedent had made a transfer under which he retained for a period not ascertainable without reference to his death, the possession or enjoyment of the right to the income of the property within the meaning of §302(c) as amended. Thereupon this action was commenced.

Plaintiff's appeal from that part of the judgment determining that the contingent remainder in the trust following the wife's life estate was properly included in the taxable estate, and denying recovery of the additional taxes paid because of its inclusion.

Before CLARK, FRANK and MEDINA, Circuit Judges.

FRANK, Circuit Judge.

May v. *Heiner*, 1930, 281 U.S. 238, dealt with a trust reserving a contingent life estate to the settlor, Mrs. May, following a life estate to her husband. The Court held that §302(c) of the 1926 Act[1] did not cover the settlor's life interest. In its opinion, the Court said: "The record fails clearly to disclose whether or

[1] Section 302(c) then provided that the gross estate should include property, "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . ."

no Mrs. May survived her husband. Apparently she did not. But this is not of special importance, since the refund should have been allowed in either event." If, then, §302(c) had remained without amendment, *May* v. *Heiner* would have required a refund in the instant case.

However, the Joint Resolution of March 3, 1931, 46 Stat. 1516—enacted to amend §302(c) at the urgent prompting of the Treasury which was alarmed by the serious consequences to the fisc of the *May* v. *Heiner* interpretation—included the added phrase "or a transfer under which the transferor . . . for . . . any period not ending before his death . . . " In 1932, Congress amended §302(c) by §803(a) of the 1932 Act [2] which included a phrase—substantially like that added in the Joint Resolution—"for any period which does not in fact end before his death," and also a second new phrase, "for any period not ascertainable without reference to his death."

If we look solely to this statutory language, it is entirely clear that—without any assistance from or need for any interpretive Regulation—it covers a contingent life interest like that in the trust before us here. So the Seventh Circuit held in *Commissioner of Internal Revenue* v. *Nathan's Estate*, 7 Cir., 159 F.2d 546.

Appellants, however, point to the Committee Reports on the 1932 amendment.[3] These Reports state that the first phrase, "or for any period which does not in fact end before his death," is but "clarifying"; and they give as an illustrative example of its coverage a case where the settlor "is to have the income from and after the death of another person until his own death and such other person predeceases him." If those Reports control the interpretation of the statute, then this first phrase does not apply to the sort of contingent life estate, of a settlor who predeceases the preceding life tenant, considered in *May* v. *Heiner*, and we have the astonishing result that the Joint Resolution, which had added virtually the same phrase, failed of its intended purpose.[4]

We must, then, construe an amendatory statute the text of which is clear and unambiguous—and undeniably reasonable if one accepts its literal meaning [5]—while its context—its "legislative history"—alone is ambiguous: (1) According to the older notion, the background or context which legitimately may be considered in construing legislation consists primarily of the circumstances surrounding the appeal to the legislature and the "mischief" or "evil" which the legislation aimed to remedy. Here the literal text is entirely in accord with such circumstances and with the aim of the statue, *i.e.*, the undoing of the *May* v. *Heiner* interpretation. (2) More recently, it has become legitimate, in the federal

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[2] Section 803(a)—carried into [§2036, 1954 Code]—reads as follows "To the extent of any interest therein of which the decedent has at any time made a transfer . by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, . . ."

[3] See 1939-1 Cum. Bull. (Pt. 2) 490, 532.

[4] See Bittker, "The Church and Spiegel Cases," 58 *Yale L.J.* (1949) 826, 867-869.

[5] We stress the reasonableness of the literal meaning, for the situation might well be different if that meaning yielded unreasonable consequences. See *e.g*, Holy Trinity Church v. United States, 143 U.S. 457, 12 S. Ct. 511, 36 L. Ed 226, Cabell v. Markham, 2 Cir., 148 F.2d 737, affirmed sub nom. Markham v. Cabell, 326 U.S. 404, 66 S. Ct. 193, 90 L. Ed. 165.

courts, also to consider more or less what Continental lawyers call "travaux preparatoires," including Committee Reports. But in respect of the statute we are now considering, (2) is at odds with (1). We think it has never been sound doctrine that a court may look at the text of an Act only when the legislative history is ambiguous. But, even under such a doctrine, in the case of the 1932 amendatory Act, we think we would be obliged to stick to the text without regard to the context. Consequently, although we confess that our conclusion is not free from all possible doubts, we think that, because of the astonishing result of resorting to the Committee Reports, we should ignore those Reports to the extent that they war with the plain and reasonable meaning of the statutory language.

There is also the second statutory phrase, "for any period not ascertainable without reference to his death," which, glove-like, fits the facts here. This second phrase the Committee Reports apparently considered a change of substance.[6] To be sure, the Reports, in giving examples of the coverage of this second phrase, did not mention a case like that at bar where the settlor predeceases the holder of the preceding life interest. As, however, Congress deemed the addition of this second phrase a substantial change, it may well be that it was intended to eradicate any part of the *May* v. *Heiner* interpretation which the Joint Resolution of 1931 and the first phrase in the 1932 amendment may conceivably have left intact.

Accordingly, we agree with *Commissioner of Internal Revenue* v. *Nathan's Estate*, 7 Cir, 159 F 2d 546. We find further support in the discussion of the "rationale" of *May* v. *Heiner* in the subsequent case of *Commissioner of Internal Revenue* v. *Estate of Church*, 335 U.S. 632, 645–646.[7] It is difficult to believe that Congress, in the 1932 statute, did not thoroughly eliminate that much-criticized rationale.[8]

2. In the *Nathan's Estate* case, the trust was created in 1941, after the issuance, in 1937 and 1938 of Regulations which unmistakably interpreted the statute to cover a contingent life estate like that of the settlor's here, even if the settlor dies before the preceding life interest. However, here Marks, the settlor, created the trust on December 21, 1935, when there was still outstanding an interpretative ruling, issued in 1934, which construed the 1932 statute as excluding such a contingent life estate. Appellants contend that the settlor reasonably relied upon that 1934 interpretative ruling when he created the trust, and that therefore, it

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[6] The Joint Resolution of 1931 had contained no similarly worded phrase.

[7] Although the Church case dealt with the phrase "intended to take effect in possession or enjoyment at or after his death," we think the reasoning of the opinion serves to dispose of the elaborate argument of appellants in the instant case that the settlor, Marks, had not "retained" anything. See especially 335 U S. at pages 645–646, 69 S. Ct 322.

[8] The Conference Report on the Technical Changes Act of 1949 states " the expression 'not ascertainable without reference to his death' as used in §811(c)(1)(B) . . . includes the right to receive the income from transferred property after the death of another person who in fact survived the transferor. . . ." See Report of Conference Committee on H.R. 5628, p. 5, 81st Cong., 1st Sess. The government suggests that this statement "specifically affirms" the rule of Nathan's Estate. Congressional views as to the meaning and intent of earlier legislation merit consideration according to circumstances, equally with other informed commentary commonly accepted as judicial aids in statutory interpretation, and may at times be highly persuasive. . . . But we think the 1949 Conference Report is not of much value or importance in the present context.

would be unconstitutional to apply, retroactively, to this trust the interpretative Regulations promulgated subsequently in 1937 and 1938.

The record is barren of evidence that the settlor actually did rely on the 1934 ruling. Even if we were to presume reliance, and even if we assumed that, where there has been reasonable reliance on a valid interpretative ruling, a retroactive change in the administrative interpretation violates due process, still we think there would be these sufficient answers to appellants' contention:

(a) The Seventh Circuit in *Nathan's Estate* held, we think correctly, that the statute is so clear that it needs no administrative interpretation, that such an interpretation is supererogatory. It follows that the 1934 ruling lacked validity, since it contradicted the statute, and that therefore the settlor's reliance is immaterial.

(b) The facts here show an absence of reasonable reliance by the settlor on the 1934 ruling, even if it be considered valid. For, as already noted, previous to his death, which occurred November 22, 1939, two Regulations—one in 1937 and another in 1938—superseded the 1934 ruling, and specifically interpreted the statute as covering a trust containing a contingent life estate of the kind he reserved. The settlor thus had ample warning, and had ample time, to divest himself of his contingent life interest. True, the trust seems to have been irrevocable. But, without revoking it, he could have released his interest. In the alternative, he could have given it to someone else; for, under the New York "law," applicable to this trust, a future contingent interest in personal or real property is alienable. *National Park Bank* v. *Billings,* 144 App. Div. 536, 129 N.Y.S. 846, affirmed 203 N.Y. 556, 96 N.E. 1122.

Affirmed.

Note

1. The Commissioner sought to tax the value of the corpus less the value, at the date of the taxpayer's death, of his wife's life interest. Does the statute require an allowance for the wife's life interest?

2. Suppose *A* transfers $100,000 in trust, reserving the right to receive the first $25,000 of income produced by the transferred property. If *A* dies before he has received $25,000, is the corpus includible in his estate on the ground that he retained the income for a "period which does not in fact end before his death"? Would it make a difference whether, having regard to his life expectancy and the trust's yield, the $25,000 was likely to be paid during his life or not? Suppose he retained the income for 20 years and died during that period. Would inclusion depend upon whether 20 years was more or less than his life expectancy? Regs. 105, Sec. 81.18; *Estate of Fry* v. *Commissioner,* 9 T.C. 503 (1947); *cf. Estate of Hays* v. *Commissioner,* 181 F.2d 169 (5th Cir. 1950); see also the 1932 committee report on the phrase "for any period which does not in fact end before his death," *supra,* p. 1107.

3. The court says that the settlor "had warning, and had ample time, to divest himself of his contingent life interest." Would a release of that interest have been a gift in contemplation of death (if the decedent died within 3 years) if his sole reason for giving it up was to avoid the estate tax? See *Allen* v. *Trust Co. of Georgia, supra,* p. 1156. If the decedent was not protected by that case and the release was treated as a gift in contemplation of death, how much would be included in the estate on its account? Recall that in *Estate of Humphrey* v. *Commissioner, supra,* p. 1159, it was said that donated property is to be valued as of the decedent's death in order "to make the transferred property cause the same tax result as if the decedent had kept it till he died instead of transferring it." But if a life estate is retained by the grantor, the *entire corpus* of the trust is includible under §2036. Does this mean that the same amount

is to be included if the life estate is released in contemplation of death? In *Re Thurston's Estate*, 36 Cal.2d 207, 223 P.2d 12 (1950), involving the California inheritance tax, the California Supreme Court stated that the entire corpus would remain taxable after a release of the life estate in contemplation of death

> If the control or interest is retained until the transferor's death, the tax is imposed as if the transferor had remained the owner of the property until his death, and disposition of the property had been through his estate. The testamentary effect of the earlier transfer cannot be altered by a later testamentary transfer, either by will or in contemplation of death. *Cf. Allen* v. *Trust Co. of Georgia*, 326 U.S. 630, 637. There is no reason to favor the transferor who relinquishes his interest in contemplation of death over the taxpayer who retains the shackles on the property until his death.

The court went on to say that even if the life interest was sold for its fair market value rather than released gratuitously, the entire corpus would be taxable if the transaction was in contemplation of death

> The requirement of adequate consideration [the California statute contained a provision similar to the parenthetical clause of §2035(a) of the 1954 Code] is designed "to prevent a man from diminishing his taxable estate by creating obligations not meant correspondingly to increase it, but intended as gifts or a means of distributing it after his death." *Commissioner* v. *Porter*, 2 Cir. 92 F.2d 426, 428. It follows that a transfer in contemplation of death that reduces the transferor's taxable estate is not supported by adequate consideration within the meaning of the tax statutes.

See, however, *Sullivan's Estate* v. *Commissioner*, 175 F.2d 657 (9th Cir. 1949), in which property owned by husband and wife in joint tenancy, which would have been included in the estate of the husband under § 2040, was transferred into a tenancy in common at a time when the husband was 77 years old and suffering from an ailment that caused his death within two months. The Tax Court held that the transfer was in contemplation of death and that the value of the entire property, rather than the value of the husband's one-half interest, was includible in his gross estate. Its approach was to ignore the severance, on the ground that it was in contemplation of death, and to tax the estate as though the transfer had not occurred. The Court of Appeals reversed on the ground that if the contract to substitute a tenancy in common for joint tenancy was a "transfer" within the meaning of §2035(a), it was "a bona fide transfer for money's worth because the younger wife's joint interest transferred to the older husband is worth at least as much as the husband's interest transferred to her." (175 F.2d at 659.) The court went on to reject the Commissioner's argument that a transfer in contemplation of death is taxable to the extent that it reduces the decedent's estate. As stated *supra*, p. 1109, the Technical Changes Act of 1949—enacted after the *Church* and *Spiegel* cases were decided—provided that the grantor of a pre-1931 trust who had retained a life estate could release it without having the transfer characterized as a gift in contemplation of death. See also Bittker, "The Church and Spiegel Cases· Section 811(c) Gets a New Lease on Life," 58 *Yale L.J.* 825, 861 n. 165 (1949).

Section E. The Relationship Between Section 2036 and Section 2038

INDUSTRIAL TRUST CO. v. COMMISSIONER

U.S. Court of Appeals, First Circuit, 1947
165 F.2d 142

Before MAGRUDER, MAHONEY and WOODBURY, Circuit Judges.

MAHONEY, Circuit Judge.

The executor under the will of Milton J. Budlong, who died on July 5, 1941,

has brought this petition for review of a decision of the Tax Court insofar as it determined a deficiency in the estate tax due.

On July 1, 1929, the decedent established four trusts, with himself as trustee, for the primary benefit of his three children, a daughter and two sons, and his sister, Mrs. George A. Woolsey, respectively. The issue of his three children were designated as remaindermen of all four trusts. A fifth trust created in the same indenture terminated prior to his decease by reason of the death of the beneficiary.

The indenture provided that the trustee should pay over to the several principal beneficiaries so long as they should respectively live, and, in the case of the decease of any of the principal beneficiaries who were children of the settlor, to their surviving children instead, such part or all of the net income of the trusts for their respective benefits as in each case the trustee in his discretion should from time to time deem advisable. It was provided, however, that with respect to Mrs. Woolsey such payment should aggregate $2,500 per annum during her life, with power in the trustee to expend such portions of the principal of her trust as might be necessary in addition to the net income thereof to produce the minimum annual payment. The trustee had discretion to add from time to time any undistributed income of any of the trusts to the principal of its respective trust. After the decedent should cease to act as trustee, the successor trustee was to pay over to Mrs. Woolsey $2,500 per annum from net income and from principal if necessary, accumulating the balance of the net income, if any. He was also to pay over to the settlor's daughter all of the net income of the trust for her benefit, not including, however, sums accumulated from prior years, and to pay over to each of the primary beneficiaries who was a son of the decedent who should have graduated from college, or should have attained the age of twenty-five years, all of the net income of the trust for his benefit, not including, however, income accumulated from prior years. The trust instrument further provided that "said trustee" should have power from time to time in his discretion to expend from the principal of said trusts such amounts as he might deem necessary for the benefit of the respective primary beneficiaries thereof or, in the case of the decease of such of them as were children of the settlor, their respective issue, in case of sickness or other emergency. There was no express reservation of power to alter, amend, revoke or terminate. The trusts were irrevocable and were not made in contemplation of death. Property was transferred to them prior to and subsequent to March 3, 1931.

The decedent on June 16, 1937 created an additional three trusts for the primary benefit of his daughter and two sons, respectively, with remainders to their respective issue. The decedent was trustee of each trust until his death. Each trust instrument provided that the trustee should pay over all the net income to the child named therein, provided that so long as the decedent should remain the sole trustee the trustee should pay over to the named child so much and no more of the net income as the trustee should in his absolute discretion determine and should add any undistributed income to the capital of the trust estate. These trusts also were irrevocable and there was no express reservation of power to alter, amend, revoke or terminate. They were not made in contemplation of death.

The Commissioner concluded that the corpora of the trusts, except for the value of Mrs. Woolsey's life annuity, were includible in decedent's gross estate

under §811(c) and (d) of the [1939] Internal Revenue Code [§§ 2036 and 2038, 1954 Code] and determined a deficiency accordingly.

The Tax Court decided that as to the 1929 trusts the right to invade the corpus in case of sickness or other emergency, even if retained by the decedent, was not a power to "alter, amend, or revoke" within §811(d) [§2038, 1954 Code] and, therefore, no part of the property transferred to the trusts before March 3, 1931 was includible in the gross estate.* But the Tax Court held that the power reserved by the decedent, even though as trustee, to distribute the income or accumulate it in his discretion, amounted to a power to designate the persons who should possess or enjoy income within the meaning of §811(c) [§2036, 1954 Code], thus making all the property transferred to the 1929 trusts after March 3, 1931 and the entire corpora of the 1937 trusts includible in the gross estate. The property transferred before March 3, 1931 was not included since this portion of §811(c) added by a joint resolution of that date has only prospective effect. *Hassett* v. *Welch*, 1938, 303 U.S. 303.† The present value of Mrs. Woolsey's life annuity of $2,500, insofar as it related to property transferred after March 3, 1931, was deducted, however, on the theory that as to this the decedent had no power to control.

The executor has petitioned for review on the ground that §811(c) does not apply to any of the trusts, and that even if it is applicable to the children's trusts it is not in the case of Mrs. Woolsey's trust. The Commissioner has not petitioned for review.

The two questions thus presented are (1) whether the corpora of trusts, the income of which could be paid to primary beneficiaries or withheld by the decedent-grantor and added to the corpus, eventually to go to the remaindermen, are includible in the decedent's gross estate under §811(c) on the ground that he possessed a right to designate the persons who should possess or enjoy the income, and (2) if so whether in the case of a trust with a primary beneficiary entitled to a minimum sum certain before the decedent could accumulate the income, the entire corpus of the trust, less the present value of the life annuity, is properly includible in the gross estate.

The taxpayer admits that the decedent had a power to determine who should receive the income as between the life tenants and the remaindermen. Nor does it contest the holding of the Tax Court that it is immaterial that the right to designate was exercisable by the decedent as "trustee." We think this clearly right in view of the reasoning of *Welch* v. *Terhune*, 1 Cir., 1942, 126 F.2d 695, certiorari denied, 1942, 317 U.S. 644, and similar cases, which although directly concerned with what is now §811 (d)(2) applies equally to §811(c).

The taxpayer contends, however, that a power to designate under §811(c) does not include a power limited only to choosing between two persons already named. An examination of the history of this phrase lends some credence to the contention. Under §811 (d) the fact that the decedent can only choose among a limited class is immaterial. *Commissioner* v. *Estate of Holmes*, 1946, 326 U.S. 480, *Chickering* v. *Commissioner*, 1 Cir., 1941, 118 F.2d 254, 139 A. L. R. 508, certiorari

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* See Jennings v Smith, *supra*, p 1080 [Ed.]

† See also §2036(b), 1954 Code. [Ed.]

denied, 1941, 314 U.S. 636. But under §811(d) only the interest that may be shifted is included in the gross estate. *Commissioner* v. *Bridgeport City Trust Co.*, 2 Cir., 1941, 124 F.2d 48, certiorari denied, 1942, 316 U.S. 672. Thus it is clear that a pre-1931 reserved power to designate who should enjoy the income was not sufficient to throw the entire corpus into the gross estate. *Estate of Edward E. Bradley*, 1943, 1 T.C. 518, affirmed sub nom. *Helvering* v. *Washington Trust Co.*, 2 Cir., 1944, 140 F.2d 87, 155 A.L.R. 845; *McFadden* v. *United States*, D.C.E.D.Pa. 1937, 20 F. Supp. 625. *Contra: Hoblitzelle* v. *United States*, 1933, 77 Ct. Cl. 639, 3 F. Supp. 331. Since even an unlimited power to designate who should enjoy the income during the life of the decedent did not require the value of the corpus to be included in the gross estate under §811(d), nor under §811(c) prior to its amendment in 1931, the plaintiff urges that this was the power at which the legislation was aimed. The argument is bolstered by the fact that the Joint Resolution of March 3, 1931 was enacted to close the gap left by the decision in *May* v. *Heiner*, 1930, 281 U.S. 238, and the three subsequent cases, *Burnet* v. *Northern Trust Co.*, 1931, 283 U.S. 782; *Morsman* v. *Burnet*, 1931, 283 U.S. 783; *McCormick* v. *Burnet*, 1931, 283 U.S. 784. The taxpayer urges that the Resolution should be interpreted in the light of that background, and that only a broad reserved power tantamount to a reserved life estate was intended to be included.[1]

Although this argument is persuasive, we find no warrant in the plain words of the statute for making a distinction between narrow and broad powers. The decedent literally had a power to designate who should enjoy the income. A distinction such as suggested would introduce numerous complexities into the administration and interpretation of this section. The taxpayer would have us draw a line between a power to select among people named in the instrument and a power to select among people at large. But this would allow easy avoidance of the tax by careful draftsmanship without any change in substance. It would be a relatively simple matter to put in the instrument a list of persons which would cover practically anyone that the decedent might ever wish to designate. In interpreting an unambiguous statute we should not assume that Congress has acted so as to allow such easy avoidance of tax. Nor would any distinction based on the number of persons among whom the decedent might choose be sound as a matter of judicial interpretation. Thus, all the property transferred to the trust for the children after March 3, 1931, and the corpora of the 1937 trusts were rightly included in the gross estate.

To the extent to which the decedent retained a power to accumulate income in the trust for Mrs. Woolsey, his sister, it is the same as the other trusts. But it differs from the others, however, in that she was always to receive $2,500 per year out of income and principal, if necessary. The decedent could accumulate

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[1] Cf. Eisenstein, "Powers of Appointment and Estate Taxes; II," 52 *Yale L. J.* 484, 540 n. 215 (1943): "The Resolution's reference to the decedent's reservation of a right to designate who shall possess or enjoy the property or its income was apparently intended to embrace a reservation analogous to a life estate, *i.e.*, the right to designate the person who would enjoy or possess the property for the duration of the decedent's life. A reserved power to determine the eventual takers of property after death was already taxable under subsections (c) and (d) of the prior versions of section 811 of the Code."

income only in excess of that amount. The Tax Court made what it considered the proper adjustment by discounting the value of the corpus of that trust by the value of the life annuity of Mrs. Woolsey. It was no doubt misled by the fact that the Commissioner, who had contended that all of the corpus of the trust for Mrs. Woolsey (including that part transferred before March 3, 1931, as well as after) should be included in the decedent's gross estate under §811(d), had excluded the value of the annuity. This may have been correct on the theory he was then pursuing that by the reservation of the power to invade in case of sickness or other emergency, the decedent had kept a string on the corpus in that he could give the corpus to her. But since she was entitled to a minimum of $2,500 per year which could come out of the corpus if necessary, this string was only over the difference between the entire corpus which he might conceivably give her and the annuity she was to receive in any event.

The Tax Court, however, held that §811(d) was not applicable but it nevertheless deducted the value of the annuity in applying §811(c). We think the Tax Court erred by using an incorrect method of computing what proportion of the corpus should be included The regulations provide that if the reservation of the right to designate pertains to a part only of the transferred property, or to a part only of income therefrom, only a corresponding proportion of the value of the transferred property is includible in the gross estate, U.S. Treas. Reg. 105, §81.19 (1942). Both parties are essentially in agreement that the Tax Court's method was wrong, but there is however a dispute as to what is the proportion that should be included.

The taxpayer argues that a four percent rate should be postulated and, since the corpus ($34,668.40) at four percent would not yield $2,500, it maintains that no part of Mrs. Woolsey's trust should be included. We cannot agree that a four percent rate should always be assumed. The taxpayer relies on the regulations providing that in valuation of annuities, life estates, and remainders, a four percent rate is proper.* But it appears to us that the taxpayer has confused two different matters. Valuation of future interests is always a guess, though it should be an informed guess. Some rate must be assumed and the regulations generally postulate the four percent rate. But even in cases of valuation there are exceptions; and other rates will be used if some valid reason is shown for so doing, *e.g.*, *Hanley* v. *United States*, 1945, 105 Ct. Cl. 638, 63 F. Supp. 73; *Security-First National Bank* v. *Commissioner*, 1937, 35 B.T.A. 815. Here the question is not one of determining the value of particular property; it is rather one of determining what portion of the property the decedent had in effect not completely relinquished because of his control of the income. There is no necessity for assuming an artificial rate when the actual income for past years can be ascertained. If for some reason the actual income over past years can not be determined, the Tax Court, whose function it is to find the facts, might be justified in assuming an average rate of four percent. But that is not our function as a reviewing court.

The Commissioner takes the position that the taxpayer has failed to show what

* Regs. 105, Sec. 81 10(j). For decedents dying after Dec. 31, 1951, the regulations provide that annuities, life estates and remainders shall be valued on a 3½ percent basis. Sec. 81.10(i). [Ed]

part of the property should not be included because of the $2,500 annuity which the decedent could not control. He thus contends that there was a failure of proof and that the Tax Court was in error in failing to include all the property transferred after March 3, 1931, although he has not petitioned for review on this point. The Commissioner would thus have us affirm the decision of the Tax Court. We do not think that such action would be proper or in accord with the power given the circuit courts of appeal to remand for a rehearing if justice requires it. [§7482(c), 1954 Code.] From the instrument, it is clear that the decedent could not control all the income, but only that in excess of $2,500. The part of the corpus transferred after March 3, 1931 necessary to produce the share of the $2,500 attributable to the post March 3, 1931 transfers should have been excluded. We see little difference between this type of reserved power and a power to designate half the income. There it seems clear that only one-half the corpus would be included. The same principle should have been applied here. We do not agree with the Commissioner's view that because the taxpayer failed to establish facts on which a fair apportionment can be made the Tax Court's determination at the erroneous figure should be sustained and this Court should not remand for further hearing There is no support for the idea that the Commissioner's determination, which is clearly without rational foundation when applied where this portion of §811(c) is involved, should be enforced because the taxpayer has not shown the exact amount. *Cf. Helvering* v *Taylor*, 1935, 293 U.S. 507, *Forbes* v. *Hassett*, 1 Cir, 1942, 124 F.2d 925, 928, and cases cited.

The case is remanded to the Tax Court on this point for further proceedings. That body may make findings as to whether the income realized ever exceeded $2,500 and thus determine whether in actuality the decedent retained any power. Even if the income did exceed $2,500 there should be excluded a proportionate part of the corpus necessary to produce an income of $2,500. We have previously remanded cases for determination of all the relevant facts in analogous situations. *Saltonstall* v. *Commissioner*, 1 Cir., 1945, 148 F.2d 396. The power to remand should be liberally exercised when the burden of proof device would otherwise work an injustice. *Cf. Underwood* v. *Commissioner*, 4 Cir., 1932, 56 F.2d 67. We think such a procedure is especially called for when the Tax Court has not proceeded on the grounds of failure of proof, but instead has acted upon a mistaken interpretation of what the Commissioner had done. *Cf. Askania Werke, A.G.* v. *Helvering*, 1938, 68 App.D.C. 315, 96 F.2d 717.

The decision of the Tax Court is affirmed in part, and reversed in part and remanded to that Court for further proceedings not inconsistent with this opinion.

MAGRUDER, Circuit Judge (dissenting in part).

While the provisions of §811(c) and 811(d) overlap to some extent, it is important to stress that whenever §811(c) is applicable, the value of the corpus is included in the decedent's gross estate, whereas in the case of transfers falling within §811(d) there must be included only the value of the particular interests the enjoyment of which had been subject to a change through the exercise of a power in the decedent to alter, *etc.* Where the enjoyment of the primary life estate is subject to a power in the decedent to withhold the income and add it to principal, such power falls within the description of §811(d), and the value of the life estate must be included in decedent's gross estate. In the present case that

would be true, it seems to me, as to all the transfers in trust, whether made before or after March 3, 1931.

But though the control which decedent had over the enjoyment of the life estates requires the value of those interests to be included in the gross estate, under §811(d), it does not follow that the same control requires the corpora of the trusts to be swept into the gross estate under §811(c). The statutory language in §811(c), describing the power over income which has the tax consequence of requiring the corpus of the trust to be included as part of the decedent's gross estate, is markedly different from the language of §811(d).

As the opinion of the court points out, the amendment to §811(c) which Congress rushed through on March 3, 1931, was prompted by three decisions of the Supreme Court handed down March 2, 1931. *Burnet* v. *Northern Trust Co.*, 283 U.S. 782; *Morsman* v. *Burnet*, 283 U.S. 783; *McCormick* v. *Burnet*, 283 U.S. 784. In the first two of these cases the grantor reserved to himself a life interest in the income (See *Commissioner* v. *Northern Trust Co.*, 7 Cir., 41 F.2d 732 and *Commissioner* v. *Morsman*, 8 Cir., 44 F.2d 902); and the 1931 amendment to §811(c) covered these cases by providing that the value of the corpus should be included in the gross estate where the grantor had reserved to himself the possession or enjoyment of or the right to the income from the property transferred. In the *McCormick* case, *supra*, the trustees had been directed to accumulate the net income and add the same to the principal, subject, however, to the following provision:

> Said Trustee shall from time to time in each year pay out of said net income for charitable uses and purposes such sums and amount of money as said first party [the grantor] shall designate and request in writing, specifying to whom the same is to be paid and the particular charitable uses and purposes to which the same is to be applied.

The *McCormick* case obviously inspired the other phrase inserted by Congress in the 1931 amendment, "the right . . . to designate the persons who shall possess or enjoy . . . the income. . . ."

I agree with the court that the foregoing phrase cannot be limited to cases where the power to designate the persons who shall enjoy the income is unrestricted. Indeed, in the *McCormick* case, the power was not unrestricted, for there the income was to be accumulated by the trustees, subject only to a power in the decedent to direct that income to be paid to charities. The possible recipients of his bounty were thus limited to a class described in the trust instrument.

But it does not seem to me that a mere power to accumulate income aptly falls within the phrase "the right . . . to designate the persons who shall possess or enjoy . . . the income . . . ." I think it more likely that if Congress had intended that the reservation of this very familiar power should have the drastic consequence of requiring the inclusion in decedent's gross estate of the whole value of the corpus, it would have explicitly so provided. A power to withhold the income from the life tenant is not a power to designate who shall enjoy the income. If the income is withheld from the life tenant and added to principal, no one will enjoy it as income. Nor does the power to accumulate income enable the holder of the power to designate who shall ultimately receive the same as augmented corpus. That is rigidly determined by the provisions of the trust instrument and is subject to contingencies which were beyond the control of the decedent. At

any particular time when a decision is made not to pay income to the life tenant but to accumulate it, it could not be known who would ultimately benefit by such accumulation.

I therefore think that §811(d) applies here rather than §811(c).

Note

Note that nothing was included in respect of the property transferred by the grantor before 1931. The Treasury sought in the Tax Court to reach this property on the ground that the settlor's power to advance principal to the beneficiaries in case of sickness or other emergency was a power to "alter, amend, or revoke." This argument was rejected by the Tax Court. But the grantor also had the power to withhold income from three of the four principal beneficiaries. Was this a power to "alter, amend, or revoke"? The Tax Court did not deal specifically with this point; and since the government did not appeal, it could not have asked the Court of Appeals to reverse the Tax Court as to the pre-1931 transfers. Note Judge Magruder's dissenting opinion, and see the *Holmes' Estate* case, *supra*, p. 1066.

ESTATE OF YAWKEY v. COMMISSIONER

Tax Court of the U. S., 1949
12 T.C. 1164

[In 1935 the decedent and his wife created three trusts, one for each of their three granddaughters, naming themselves and their son-in-law as trustees. Each trust provided that until the beneficiary became 25, the trustees should pay for her benefit (or distribute to her, in their discretion) "such portion of the income as they deem for her best interest, retaining any balance not so used as an accumulation of income", after the beneficiary reached the age of 25, the income was to be distributed to her quarterly. The trustees also had the power to transfer to the beneficiary, after she reached the age of 30, "such portions of the principal as in their judgment they deem for the best interest of the beneficiary." Upon the death of the income beneficiary, the corpus and any undistributed income of each trust was to go to her lineal descendants, with gifts over should there be no lineal descendants.]

Opper, *Judge:* Whether any part of decedent's *inter vivos* transfers is to be included in the gross estate depends, as the case is presented and as we view the issues, on the answer to three questions. Respondent proposed the inclusion of the value at decedent's death of three trusts established by him for the benefit of his three granddaughters on two theories: First, that decedent, being a trustee, had a power alone or in conjunction with one of the two other trustees to alter, amend, or revoke the trusts, as envisaged by section 811(d)(2), [1939] Internal Revenue Code [§2038(a)(2), 1954 Code]; and, second, that in the same manner decedent had the right to designate the persons who should enjoy the income from the property within the meaning of section 811(c) [§2036(a)(2), 1954 Code]. Under the latter determination a smaller amount was proposed for inclusion, apparently because one of the three granddaughter beneficiaries had arrived at the age of 25 years when decedent died, and the trusts required the payment of all of the income to the respective beneficiaries upon their reaching that age.

Petitioner insists in the first place that decedent had no power or right in the

premises because there was an adequate external standard by which the conduct of the trustees was to be measured and this so circumscribed their actions that neither provision applies. This is the first question, and, if the contention prevailed, it would dispose of the entire controversy. But we can not sustain it.

The only limitation on the use of the trustees' discretion was that what they decided on was to be for the "best interest" of the beneficiary. In the absence of fraud, bad faith, or a mischievously erroneous act, courts of equity will not interfere when the trustees are acting within the scope of their designated discretion. "It is quite true that where the manner of executing a trust is left to the discretion of trustees, and they are willing to act, and there is no mala fides, the court will not ordinarily control their discretion as to the way in which they exercise the power. . . . But the court will interfere wherever the exercise of discretion by the trustees is infected with fraud or misbehavior, or they decline to undertake the duty of exercising the discretion, or generally where the discretion is mischievously and erroneously exercised. . . ." *Colton* v. *Colton,* 127 U.S. 300. We can not regard the language involved as limiting the usual scope of a trustee's discretion. It must always be anticipated that trustees will act for the best interests of a trust beneficiary, and an exhortation to act "in the interests and for the welfare" of the beneficiary does not establish an external standard. *Estate of Albert E. Nettleton,* 4 T.C. 987, 992; *Estate of Milton J. Budlong,* 7 T.C. 756, 763; modified sub nom. *Industrial Trust Co.* v. *Commissioner* (C.C.A., 1st Cir.), 165 Fed.(2d) 142. Those words would be implied if they were not expressed, and they add no further limitation than would exist in any trust for that reason. See *Helvering* v. *Helmholz,* 296 U.S. 93. We accordingly concur in respondent's view that under *Estate of Milton J. Budlong, supra,* petitioner's power to designate the income beneficiary is not sufficiently restricted to limit the application of section 811(c) and (d).

For an additional reason, it is contended that section 811(d) is inapplicable. This presents the second question. The clause upon which respondent relies for his conclusion that the enjoyment of the property was subject to alteration or termination through the exercise of a power by decedent is the provision permitting the trustees to transfer any part of the principal to a beneficiary after she becomes 30 years of age. At decedent's death all of the beneficiaries were under 30. The condition for the exercise of the power had accordingly not yet been fulfilled Under authorities now too firmly established to question, a power based on such a future contingency does not suffice to bring the situation within section 811(d). *Jennings* v. *Smith* [*supra,* p. 1079], *Estate of Milton J. Budlong, supra.* And we find nothing in the language or result of the two cases recently decided by the Supreme Court to warrant a departure from the rule thus decisively settled. *Commissioner* v. *Estate of Church,* 335 U.S. 632; *Estate of Spiegel* v. *Commissioner,* 335 U.S. 701. The phraseology in these opinions most heavily relied upon by respondent[1] deals exclusively with title, possession, and

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[1] ". . In the Church case we stated that a trust transaction cannot be held to alienate all of a settlor's 'possession or enjoyment' under §811(c) unless it effects 'a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal

enjoyment. This decedent could under no circumstances and in no contingency retain or recapture any of these attributes. The most that he could ever do and the most that respondent suggests that he could do was to change the title, possession, or enjoyment of the principal from the remaindermen to the life beneficiary. That would be an aspect of the transfers rendering them taxable, if the power existed currently, not under the survivorship theory of the *Hallock* case,[2] nor as intended to take effect at death, nor by retention of an interest in the income, *cf. May* v. *Heiner*, 281 U.S. 238, but under the express language of section 811(d), which covers a power to alter or terminate. It thus resembles such cases as *Jennings* v. *Smith, supra.* But there is no assertion or implication of a reversionary interest in income or principal to assimilate the situation to that in the *Church* and *Spiegel* cases.

Most important, these cases dealt with section 811(c), while the provision we are now considering is section 811(d)(2). The difference in the statutory language seems to us, especially in the light of the decided cases, to carry decisive significance with respect to the time of the existence of decedent's retention. Section 811(c) uses the language "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death," whereas, section 811 (d)(2) employs the simple concept "at the date of his death." While it is true section 811(d)(3) [§2038(b),1954 Code] lists some legislative tests by which this approach may be considered as modified, it does not reach the present situation. Decedent's power did not exist at his death under cases like *Jennings* v. *Smith, supra*, and *Estate of Milton J. Budlong, supra*, and its absence was not due to any such mere formality as the giving of notice or expiration of a formal waiting period *Cf. Estate of Paul Loughridge*, 11 T.C. 968, 978. The inapplicability of the *Church* and *Spiegel* cases, dealing as they did with the entirely different language of section 811(c), thus seems to us confirmed. Inclusion under section 811(d) must accordingly be rejected.

The final proposition advanced by petitioner, presenting the third question, is that section 811(c) is equally inapplicable both because decedent could not "designate" the persons who should enjoy the income, and, second, because he did not have "the right" to exercise it. The first statement is drawn from the provisions of the trust which, while permitting the trustees to withhold income from a life beneficiary under 25, require that it either be paid to her subsequently, or added to corpus. It is insisted that a complete designation of the ultimate taker is thus withheld from the trustees. The effect, however, of an addition to princi-

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title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies.' We add to that statement, if it can be conceived of as an addition, that it is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective. In either event the settlor has not parted with all of his presently existing or future contingent interests in the property transferred. He has therefore not made that 'complete' kind of trust transfer that §811(c) commands as a prerequisite to a showing that he has certainly and irrevocably parted with his 'possession or enjoyment.' . . ." [Estate of Spiegel v Commissioner, 335 U.S. 701.]

[2] Helvering v. Hallock, 309 U.S 106.

pal which was within the province of decedent and his cotrustees would be to shift the enjoyment from the life beneficiary to the ultimate taker of the principal, a remainderman whose identity might be indeterminate at the time but whose rights would thereby be tentatively fixed. *Estate of Milton J. Budlong, supra.* The "right" of decedent in the premises is questioned because decedent's two cotrustees could by their combined action frustrate any decision on his part under the majority rule established in the trust instrument. But if decedent joined with either of the other trustees, his action became effective. In our view that is what is meant by the statutory phrase "the right either alone or in conjunction with any person." Granted that decedent did not possess the right alone, it seems to us he clearly retained it in conjunction with the cotrustees. *Estate of John Moir,* 47 B.T.A. 765. We conclude that respondent's determination under section 811(c), which, as we have said, affects only a portion of the transfers, was proper and must be sustained. . . .

Note

1. One of the three trusts was excluded because the power to distribute or accumulate income had terminated before the decedent's death, when the beneficiary reached the age of 25. (Thereafter, the trustees were *required* to distribute the income to her.) Why does the expiration of a power before the decedent's death remove it from the reach of § 2036(a)? Note the assumption in *Marks* v. *Higgins, supra,* p. 1114, that the release of a retained life estate insulates the trust from §2036.

Does the decedent have a power "at the time of his death" under §2038 if he could not exercise it immediately before his death because of incompetence, perhaps caused by the last illness itself? In *Hurd* v. *Commissioner,* 160 F.2d 610, 613 (1st Cir. 1947), a power held by the grantor as trustee was charged against him despite his incapacity, but the court indicated that the result would have been otherwise had he resigned or been removed before death. It also hinted, however, that if a successor fiduciary had been appointed to act for him, he would be considered as still possessing the power at the time of his death.

2. Although the power to accumulate the income of the third trust had expired because the beneficiary had reached the age of 25 before the decedent's death, the decedent had also reserved the power to advance corpus to the income beneficiary. If the power to withhold income is a power to "designate" who shall enjoy the income under §2036(a)(2), as the court holds, was the power to advance corpus also within §2036(a)(2) as a power to designate who shall enjoy the property?* (The power could not be exercised until the beneficiary reached the age of 30, an event that had not occurred when the decedent died, but the court holds that §2036, unlike §2038, does not require that the power be exercisable at the time of the decedent's death.) Assuming that the power to advance corpus was within §2036, would only the value of the entire trust be taxable, or would allowance have to be made for the value of the life interest? Note that under §2036 a power over the income alone brings the entire trust into the gross estate. Is there any reason why a power over the remainder alone should do less?

3. See again *Commissioner* v. *Hager's Estate, supra,* p. 1070. Note that the trusts were created in 1924. Would the case be decided in the same way today, now that the

* Apparently the government did not make this argument: the deficiency notice claimed that the power to distribute or accumulate income was within the reach of both § 2036 and § 2038, but only §2038 was cited as authority for reaching the power to advance principal (12 T.C. at 1168–9.)

rule of *May* v. *Heiner* has been restored? If the grantor had retained the income for himself in 1924, when the trusts were created, they would not be includible because of §2036(b). Should the lesser power to withhold or distribute the income result in a tax on the entire value of the trusts under §2038? Were the other powers retained by the grantor sufficient by themselves to require the trusts to be included? See Note, Quantum Includible in Gross Estate under IRC 811(c) and (d), 49 *Col. L. Rev.* 1011 (1949), written before the restoration of *May* v. *Heiner*.

4. Would it matter whether the power to accumulate income of the two trusts that were included in the *Yawkey* case was taxed under §2036 [old §811(c)] or under §2038 [old §811(d)]? If post-1931 transfers had been before the Supreme Court in *Porter* v. *Commissioner, supra*, p. 1061, *Estate of Holmes* v. *Commissioner, supra*, p. 1066, and *Helvering* v. *City Bank Farmers Trust Co., supra*, p. 1083, would §2036 have been applicable? What of the *Lober* case, *supra*, p. 1069? See *Struthers* v. *Kelm*, 218 F.2d 810 (8th Cir. 1955). Does §2036 reach all post-1931 transfers that can be reached by §2038? Lewis. "Transfers in Trust under the New Estate Tax Law," 3 *Amer. U. Tax Inst.* 125, 130–131 (1951).

Section F. Transfers Taking Effect at Death: Section 2037

Section 2037, dealing with transfers taking effect at death, is a 1954 revision of a provision that came into the statute in 1949. From 1916 to 1949, transfers of the type now reached by §2037 were included in the gross estate only to the extent that they constituted transfers "intended to take effect in possession or enjoyment at or after [the decedent's] death." See again *supra*, p. 1104.

The scope of §2037 of the present law can best be examined by assuming a transfer of this type: H transfers property in trust to pay the income to W, his wife, for her life, on W's death, the corpus is to be distributed to H if he is living; otherwise to S, H's son, or to S's estate. The requirement of §2037(a)(1) is satisfied, since S can obtain possession or enjoyment of the property only by surviving H, the transferor. Whether §2037(a)(2) is satisfied depends upon whether immediately before H's death the value of his reversionary interest exceeds 5 per cent of the value of the property. If H should die at 55 and if his wife is then 40, his reversionary interest would have been worth, immediately before his death, about 13 per cent of the value of the trust corpus. Put another way, the present worth of $1.00 due at the death of the younger of two persons, aged 55 and 40, provided the older survives, is about $0.13. If H dies at 55 when his wife is only 25, however, H's reversionary interest would be worth slightly less than 5 per cent of the value of the corpus.* In the former case, since the decedent's reversionary interest was worth more than 5 per cent of the corpus, the trust would be includible under §2037. (The amount to be included would be the corpus less the value of the wife's life interest, since her interest was not dependent upon the husband's death.) In the latter case, however, since the rever-

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* The student who wishes to see how these values are derived, or to work out the appropriate factor for other ages, will find the formula set out in Example 6, *Actuarial Values for Estate and Gift Tax* (IRS Publication No. 11, 1955), p. 10.

sionary interest was worth less than 5 per cent of the corpus, the trust would not be includible under §2037.*

The language of §2037 is relatively straightforward, presenting no more than its fair share of minor difficulties. But why *are* these the tests for including transfers taking effect at death? Are there any similar transfers that escape §2037? If so, why? If this provision is amended, what form might the changes take? A study of the evolution of §2037 from the primitive postponed-possession-or-enjoyment clause will aid in answering these questions; otherwise, §2037 is like a military order sent by a distant headquarters to a unit that must act on it in ignorance of its setting or purpose. On the other hand, the taxation of transfers taking effect at death has had so tortuous a history that abbreviation is essential. What follows is only a summary.†

By accident or otherwise, the first three cases in this area to reach the Supreme Court arrived in inverse order to the strength of the government's position. In *Shukert* v. *Allen,* 273 U.S. 545 (1927), the government maintained that a transfer in trust to accumulate the income for 30 years, with distribution of the corpus and accumulated income to be made to the settlor's children or their issue at that time, was includible in the transferor's estate. The settlor died shortly after creating the trust. Because the term of the trust was greater than the settlor's life expectancy (about 16 years) when the transfer was made, the government asserted that the transfer was "intended to take effect in possession or enjoyment at or after his death." The Supreme Court held to the contrary, but the ground of its decision was not altogether clear:

> The transfer was immediate and out and out, leaving no interest remaining in the testator. The trust in its terms has no reference to his death but is the same and unaffected whether he lives or dies. Although the Circuit Court of Appeals seems to have thought otherwise, the interest of the children respectively was vested as soon as the instrument was executed, even though it might have been divested as to any one of them in favor of his issue if any, or of the surviving beneficiaries, if he died before the termination of the trust. See Gray, *The Rule Against Perpetuities*, §108(3). It seems plain from the little evidence that was put in that the testator was not acting in contemplation of death as a motive for his act, or otherwise, except in the sense that he was creating a fund intended to secure his children from want in their old age, whoever might dissipate the considerable property that he retained and left at his death; and that being fifty-six years old, if he thought about it, he would have contemplated the possibility or probability of his being dead before the emergency might arise. Of course it was not argued that every vested interest that manifestly would take effect in actual enjoyment after the grantor's death was within the statute There certainly is no transfer taking effect after his death to be taxed under [the clause relating to transfers intended to take effect in possession or enjoyment at or after death].
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> It is not necessary to consider whether the petitioner goes too far in contending that this clause should be construed to refer only to transfers of property the possession or enjoyment of which does not pass from the grantor until his death. But it seems to us tolerably plain, that when the grantor parts with all his interest in the property to other persons in trust, with no thought of avoiding taxes, the fact that the income vested in the beneficiaries was to be accumulated for them instead of being handed

* Would the value of the husband's reversionary interest be includible under §2033?

† For a complete history of the period 1916–45, see Eisenstein, "Estate Taxes and the Higher Learning of the Supreme Court," 3 *Tax L. Rev.* 395, 421–502 (1948).

to them to spend, does not make the trust one intended to take effect in possession or enjoyment at or after the grantor's death.

Believing that it might have lost *Shukert* v. *Allen* because the term of the trust was not expressly linked to the settlor's death, the government soon sought review of another decision involving five trusts whose terms were dependent on the settlor's death. *Reinecke* v. *Northern Trust Co.*, 278 U.S. 339 (1929). The decedent had created five trusts,* four of which were to end five years after his death or upon the death of the life tenants, whichever occurred first. The fifth trust was to terminate five years after his death or upon the death of the life tenant, whichever occurred later. The Court held that these five trusts were not reached by the postponed-possession-or-enjoyment clause:

But the question much pressed upon us remains, whether, the donor having parted both with the possession and his entire beneficial interest in the property when the trust was created, the mere passing of possession or enjoyment of the trust fund from the life tenants to the remaindermen after the testator's death, as directed, and after the enactment of the statute, is included within its taxing provisions. That question, not necessarily involved, was left unanswered in *Shukert* v. *Allen*, 273 U.S. 545. There the gift of a remainder interest, having been made without reference to the donor's death, although it did in fact vest in possession and enjoyment after his death, was held not to be a transfer intended to take effect in possession or enjoyment at or after the donor's death, and for that reason not to be subject to the tax. But here the gift was intended to so take effect, although the transfer which effected it preceded the death of the settlor and was itself not subject to the tax unless made so by the circumstances that the possession or enjoyment passed as indicated.

In its plan and scope the tax is one imposed on transfers at death or made in contemplation of death and is measured by the value at death of the interest which is transferred. . . It is not a gift tax, and the tax on gifts once imposed by the Revenue Act of 1924 has been repealed, 44 Stat 126. One may freely give his property to another by absolute gift without subjecting himself or his estate to a tax, but we are asked to say that this statute means that he may not make a gift *inter vivos*, equally absolute and complete, without subjecting it to a tax if the gift takes the form of a life estate in one with remainder over to another at or after the donor's death. It would require plain and compelling language to justify so incongruous a result and we think it is wanting in the present statute.

It is of significance, although not conclusive, that the only section imposing the tax, §401 [Revenue Act of 1921] does so on the net estate of decedents, and that the miscellaneous items of property required by §402 to be brought into the gross estate for the purpose of computing the tax, unless the present remainders be an exception, are either property transferred in contemplation of death or property passing out of the control, possession or enjoyment of the decedent at his death. They are property held by the decedent in joint tenancy or by the entirety, property of another subject to the decedent's power of appointment, and insurance policies effected by the decedent on his own life, payable to his estate or to others at his death. The two sections, read together, indicate no purpose to tax completed gifts made by the donor in his lifetime not in contemplation of death, where he had retained no such control, possession or enjoyment. In the light of the general purpose of the statute and the language of §401 explicitly imposing the tax on net estates of decedents, we think it at least doubtful whether the trusts or interests in a trust intended to be reached by the phrase in §402(c)

* Two other trusts involved in the same case were revocable, and were held to be includible in the gross estate. The other five trusts were revocable with the consent of the beneficiaries, but this was held irrelevant under the statute then in effect. *Supra*, p. 1084.

"to take effect in possession or enjoyment at or after his death," include any others than those passing from the possession, enjoyment or control of the donor at his death and so taxable as transfers at death under §401. That doubt must be resolved in favor of the taxpayer. . . . Doubts of the constitutionality of the statute, if construed as contended by the government, would require us to adopt the construction, at least reasonably possible here, which would uphold the act.

After *Reinecke* v. *Northern Trust Co.* was decided, the government gave up the effort to tax transfers merely because they were contingent on the transferor's death — where his life was only a measuring stick, as it were. Nor did the Treasury ask Congress to change the law, possibly because of the constitutional doubts voiced in the last sentence quoted above. Not until 1949, as will be seen, was this type of transfer again threatened by the estate tax.

In the meantime, the government sought to make the most of the statements in *Shukert* v. *Allen* and *Reinecke* v. *Northern Trust Co.* that the proper province of the postponed-possession-or-enjoyment clause was the transfer under which possession or enjoyment passes "from" the transferor at his death. One branch of the Treasury's attack was on transfers with reservation of income; this attack was routed in 1931 by *May* v. *Heiner*, as has been described *supra*, p. 1105, and Congress had to come to the aid of the Treasury by enacting what is now §2036. The other type of transfer which the Treasury sought to tax after *Reinecke* v. *Northern Trust Co.* was the trust with a reversionary interest retained by the transferor, the type described at the beginning of this section. If such a transfer was not reached by the postponed-possession-or-enjoyment clause, the Treasury might have reasoned, what *was* that clause's function?

In seeking to apply the statutory phrase to transfers with reversionary interests, the Treasury seemed at long last to be on the right track. In *Klein* v. *United States*, 283 U.S. 231 (1931), the Supreme Court unanimously held for the government with respect to such a transfer. The grantor had created a trust to pay the income to his wife for her life. At her death, the property was to revert to the grantor if living; but if he predeceased her, she was to get the property in fee simple. He died before his wife, and the court held that the property was includible in his estate:

Nothing is to be gained by multiplying words in respect of the various niceties of the art of conveyancing or the law of contingent and vested remainders. It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate [*i.e.*, fee simple ownership rather than a life estate] into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed. (283 U.S. at 234.)

But only four years later, the "niceties of the art of conveyancing" turned out to be more durable, and profitable, than was thought. The Supreme Court was asked to review two cases, each involving trusts to pay the income to a child of the grantor for the child's life. In one, *Helvering* v. *St. Louis Union Trust Co.*, 296 U.S. 39 (1935), there were gifts over on the child's death, but if the child predeceased the settlor, the trust was to terminate and the property was to revert to the settlor. The settlor predeceased the life tenant. The Supreme Court, by a 5-4 vote, held that the property was not includible:

The grantor here, by the trust instrument, left in himself no power to resume ownership, possession, or enjoyment, except upon a contingency in the nature of a condition

subsequent, the occurrence of which was entirely fortuitous so far as any control, design, or volition on his part was concerned. After the execution of the trust he held no right in the trust estate which in any sense was the subject of testamentary disposition. His death simply put an end to what, at best, was a mere possibility of a reverter by extinguishing it; that is to say, by converting what was merely possible into an utter impossibility. (296 U.S. at 43.)*

The *Klein* case was distinguished on the ground that:

only a life estate was vested, the remainder being retained by the grantor; and whether that should ever become vested in the grantee depended upon the condition precedent that the grantor die during the life of the grantee. The grantor having died first, his death clearly effected a transmission of the larger estate to the grantee. But here the grantor parted with the title and all beneficial interest in the property, retaining no right with respect to it which would pass to any one as a result of his death. Unlike the *Klein* case, where the death was the generating source of the title, here, as the court below said, the trust instrument and not the death was the generating source. The death did not transmit the possibility, but destroyed it. (296 U.S. at 45–6.)

There was, clearly enough, only a verbal distinction between taxable *Klein* reversionary interests (retained by the grantor subject to divestment if he predeceased the beneficiary) and non-taxable *St. Louis Union Trust Co.* reversionary interests (contingent on the beneficiary's predeceasing the settlor). The distinction was administratively unworkable, and within five years the problem was back in the Supreme Court when certiorari was granted in three cases involving reversionary interests created by diverse legal formulas. Under the style of *Helvering* v. *Hallock*, 309 U.S. 106 (1940), the Supreme Court decided all three cases for the government:

The terms of these grants [in the cases before the Court] differ in detail from one another, as all three differ from the formulas of conveyance used in the *Klein* and *St. Louis Trust* cases. It therefore becomes important to inquire whether the technical forms in which interests contingent upon death are cast should control our decision. If so, it becomes necessary to determine whether the differing terms of conveyance now in issue approximate more closely those used in the *Klein* case and are therefore governed by it, or have a greater verbal resemblance to those that saved the tax in the *St. Louis Trust* cases. Such an essay in linguistic refinement would still further embarrass existing intricacies. It might demonstrate verbal ingenuity, but it could hardly strengthen the rational foundations of law. The law of contingent and vested remainders is full of casuistries. There are great diversities among the several states as to the conveyancing significance of like grants; sometimes in the same state there are conflicting lines of decision, one series ignoring the other. Attempts by the Board of Tax Appeals and the Circuit Courts of Appeal to administer §302(c) [the postponed-possession-or-enjoyment clause] by reference to these distinctions abundantly illustrate the inevitable confusion. One of the cases at bar, No. 399, reveals vividly the snares which inevitably await an attempt to base estate tax law on the "niceties of the art of conveyancing." In connection with the ascertainment of its own death duties, the Supreme Court of Errors of Connecticut defined the nature of the interest which the decedent in that case retained after his *inter vivos* transfer. *Bryant* v. *Hackett*, 118 Conn. 233; 171 A. 664. And yet the nature of that interest under Connecticut law and the scope of the Connecticut court's adjudication of that interest were made the subject of lively controversy before us. The importation of these distinctions and controversies from the law of property into the administration of the estate tax pre-

* The other case, *Becker* v. *St. Louis Union Trust Co.*, 296 U.S. 48 (1935), involved a similar trust and was decided in the same way.

cludes a fair and workable tax system. Essentially the same interests, judged from the point of view of wealth, will be taxable or not, depending upon elusive and subtle casuistries which may have their historic justification but possess no relevance for tax purposes. These unwitty diversities of the law of property derive from medieval concepts as to the necessity of a continuous seisin. Distinctions which originated under a feudal economy when land dominated social relations are peculiarly irrelevant in the application of tax measures now so largely directed toward intangible wealth.

Our real problem, therefore, is to determine whether we are to adhere to a harmonizing principle in the construction of §302(c), or whether we are to multiply gossamer distinctions between the present cases and the three earlier ones. Freed from the distinctions introduced by the *St. Louis Trust* cases, the *Klein* case furnishes such a harmonizing principle. Does, then, the doctrine of *stare decisis* compel us to accept the distinctions made in the *St. Louis Trust* cases as starting points for still finer distinctions spun out of the tenuousities of surviving feudal law? We think not. We think the *Klein* case rejected the presupposition of such distinctions for the fiscal judgments which §302(c) demands.

We recognize that *stare decisis* embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations. But *stare decisis* is a principle of policy and not a mechanical formula of adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience.

Nor have we in the *St. Louis Trust* cases rules of decision around which, by the accretion of time and the response of affairs, substantial interests have established themselves. No such conjunction of circumstances requires perpetuation of what we must regard as the deviations of the *St. Louis Trust* decisions from the *Klein* doctrine. We have not before us interests created or maintained in reliance on those cases. We do not mean to imply that the inevitably empiric process of construing tax legislation should give rise to an estoppel against the responsible exercise of the judicial process. But it is a fact that in all the cases before us the settlements were made and the settlors died before the *St. Louis Trust* decisions.*

Nor does want of specific Congressional repudiations of the *St. Louis Trust* cases serve as an implied instruction by Congress to us not to reconsider, in the light of new experience, whether those decisions, in conjunction with the *Klein* case, make for dissonance of doctrine. It would require very persuasive circumstances enveloping Congressional silence to debar this Court from re-examining its own doctrines. To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities. Congress may not have had its attention directed to an undesirable decision; and there is no indication that as to the *St. Louis Trust* cases it had, even by any bill that found its way into a committee pigeon-hole. Congress may not have had its attention so directed for any number of reasons that may have moved the Treasury to stay its hand. But certainly such inaction by the Treasury can hardly operate as a controlling administrative practice, through acquiescence, tantamount to an estoppel barring reëxamination by this Court of distinctions which it had drawn. Various considerations of parliamentary tactics and strategy might be suggested as reasons for the inaction of the Treasury and of Congress, but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.

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* The Treasury Department subsequently provided by regulation that property transferred between November 11, 1935 (the date of the decisions in the *St. Louis Union Trust Co.* cases) and January 29, 1940 (the date of the *Hallock* decision) would not be taxed if (a) the Commissioner determines that the transfer was made in the image of the *St. Louis Union Trust Co.* limitations rather than on the *Klein* model, and (b) the transfer was reported as a completed gift without allowance for the donor's reversionary interest. The Commissioner's determination is final. Regs. 105, Sec. 81.17(c)(3). See Internal Revenue Code, §7805(b), and *Helvering* v. *Griffiths,* 318 U.S. 371, 397–399 (1943). [Ed.]

This Court, unlike the House of Lords, has from the beginning rejected a doctrine of disability at self-correction. Whatever else may be said about want of Congressional action to modify by legislation the result in the *St. Louis Trust* cases, it will hardly be urged that the reason was Congressional approval of those distinctions between the *St. Louis Trust* and the *Klein* cases to which four members of this Court could not give assent. By imputing to Congress a hypothetical recognition of coherence between the *Klein* and the *St. Louis Trust* cases, we cannot evade our own responsibility for reconsidering, in the light of further experience, the validity of distinctions which this Court has itself created. Our problem then is not that of rejecting a settled statutory construction. The real problem is whether a principle shall prevail over its later misapplications Surely we are not bound by reason or by the considerations that underlie *stare decisis* to persevere in distinctions taken in the application of a statute which, on further examination, appear consonant neither with the purposes of the statute nor with this Court's own conception of it. We therefore reject as untenable the diversities taken in the *St. Louis Trust* cases in applying the *Klein* doctrine—untenable because they drastically eat into the principle which those cases professed to accept and to which we adhere.

Chief Justice Stone concurred in the result on the ground that the *Klein* case was controlling in all instances before the Court. Justices Roberts and McReynolds dissented, asserting that there was a difference "of substance, not merely of terminology" between the *Klein* and *St. Louis Union Trust Co.* trusts, but that even if there were not, the *St. Louis Union Trust Co.* cases should be preserved out of respect for the doctrine of *stare decisis* and because Congress had reenacted the statute without change after these cases were decided.

The *Hallock* case at first seemed to be the final step of a long journey; now we know that it was only the end of the beginning. Two questions that particularly called for decision were these:

1. Did the statute reach a reversionary interest that was not expressly reserved by the grantor but instead arose by operation of law? In the cases passed on by the Supreme Court, the reversionary interest had been created by the express language of the trust indenture. But what if H transfers property in trust to pay the income to W for H's life, remainder to H's children living at the time of his death, with no gift over if the children all predecease H? In these circumstances H would have a reversionary interest by operation of law. It was argued that such a trust was not reached by the statute, however, at least not without proof that the transfer was "intended" to take effect in possession or enjoyment at or after death. It was of course possible H had no intention of reserving anything, and that his reversionary interest existed only because the draftsman failed to provide for a final gift over. But even an *express* reservation of a reversionary interest might result from a draftsman's caution and not from the settlor's deliberation, and the *Hallock* case did not make any inquiry into the question of whether the reversionary interests there involved were *deliberately* retained.

2. Was the "remoteness" of the reversionary interest relevant? * The principal Supreme Court cases had all concerned settlors who would recapture transferred property if they outlived a wife or a child. The possibility of survivorship

* In 1945, the Supreme Court said in several cases that the remoteness of the decedent's reversionary interest was irrelevant. But there were certain special circumstances in these cases that led some observers to think that the issue was not yet foreclosed. See Bittker, "The Church and Spiegel Cases: Section 811(c) Gets a New Lease on Life," 58 *Yale L. J.* 825, 836 n.65 (1949).

was sufficiently substantial so that the settlor might have retained the reversionary interest deliberately, and perhaps a conclusive presumption that the transfer was "intended" to take effect in possession or enjoyment at or after his death was warranted. But what if a settlor transfers property in trust for his wife for his life, remainder to her if she survives him, otherwise to those of his children and their issue who survive him, with a reversionary interest in the settlor's estate if his wife, his children, and the issue of his children all predecease him? See *Estate of Goodyear* v. *Commissioner*, 2 T.C. 885 (1943), where a trust fund of about $350,000 would have reverted to the decedent only if she had survived a son, four grandchildren, and their issue, eight great-grandchildren being alive at the time of her death; the value of the reversionary interest was $0.0000000000876. If the settlor's reversionary interest was virtually worthless, because conditioned on a remote possibility, was the transfer "intended to take effect in possession or enjoyment at or after his death," as that clause was interpreted in the *Hallock* case?

In October, 1947, *Spiegel's Estate* v. *Commissioner* and *Commissioner* v. *Church*, which raised both of these questions, were argued in the Supreme Court. In both cases, the government asserted that the grantor of a trust possessed a remote reversionary interest arising by operation of law, because the instrument of transfer did not provide for all contingencies. In the *Spiegel* case, the corpus was worth about $1.1 million when the decedent died, and its inclusion in the estate produced an estate tax of about $450,000; the grantor's reversionary interest (dependent on out-living his children and their issue) was worth $4,500 when the trust was created and about $85 just before he died.* On the last day of the 1947 term, the Supreme Court ordered reargument (68 Sup. Ct. 1522, 1524), requesting counsel to discuss nine questions which in effect inquired whether the Court had been mistaken in its view of the postponed-possession-or-enjoyment clause in every important case before *Helvering* v. *Hallock*. The cases were reargued in accordance with these orders in October, 1948 and were decided in January, 1949. In deciding the *Church* case, in which the decedent had not only a reversionary interest but also a pre-1931 life estate, the Court (three justices dissenting) did not confine itself to the reversionary interest issue, but decided the case by overruling *May* v. *Heiner*, as stated *supra*, p. 1108. Referring to the fact that Church had retained a life estate in the transferred property, the Court said:

> How is it possible to call this trust transfer "complete" except by invoking a fiction? Church was sole owner of the stocks before the transfer. Probably their greatest property value to Church was his continuing right to get their income. After legal title to the stocks was transferred, somebody still owned a property right in the stock income. That property right did not pass to the trust beneficiaries when the trust was executed, it remained in Church until he died. He made no "complete" gift effective before that date, unless we view the trust transfer as a "complete" gift to the trustees. But Church gave the trustees nothing, either partially or completely. He transferred no right to them to get and spend the stock income. And under the teaching of the *Hallock* case, quite in contrast to that of *May* v. *Heiner*, passage of the mere technical legal title to a trustee is not necessarily crucial in determining whether and

* The existence of a reversionary interest was disputed in both cases; the Supreme Court accepted a lower court determination that there was one in the Spiegel case, and did not reach this issue in the Church case.

when a gift becomes "complete" for estate tax purposes. Looking to substance and not merely to form, as we must unless we depart from the teaching of *Hallock*, the inescapable fact is that Church retained for himself until death a most valuable property right in these stocks—the right to get and to spend their income. Thus Church did far more than attach a "string" to a remotely possible reversionary interest in the property, a sufficient reservation under the *Hallock* rule to make the value of the corpus subject to an estate tax. Church did not even risk attaching an unbreakable cable to the most valuable property attribute of the stocks, their income. He simply retained this valuable property, the right to the income, for himself until death, when, for the first time the stock with all its property attributes "passed" from Church to the trust beneficiaries. Even if the interest of Church was merely "obliterated," in *May* v. *Heiner* language, it is beyond all doubt that simultaneously with his death, Church no longer owned the right to the income; the beneficiaries did. It had then "passed." It never had before. For the first time, the gift had become "complete."

Thus, what we said in *Hallock* was not only a repudiation of the reasoning which was advanced to support the two cases (*St. Louis Trust* and *Becker*) that *Hallock* overruled, but also a complete rejection of the rationale of *May* v. *Heiner* on which the two former cases had relied. *Hallock* thereby returned to the interpretation of the "possession or enjoyment" section under which an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies. See *Shukert* v. *Allen*, 273 U.S. 545, 547; *Smith* v. *Shaughnessy*, 318 U S. 176

Unlike Church, Spiegel had not retained a life interest. In deciding the *Spiegel* case, therefore, the Court had to decide the effect of a remote reversionary interest arising by operation of law. It held that reversionary interests arising by operation of law were as fatal as those that were expressly reserved, and that the remoteness of the decedent's interest was irrelevant·

First. In *Commissioner* v. *Church*, we have discussed the *Hallock* holding in relation to the scope of the "possession or enjoyment" provision of §811(c) and need not elaborate what we said there. What we said demonstrates that the taxability of a trust corpus under this provision of §811(c) does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer. In the *Church* case we stated that a trust transaction cannot be held to alienate all of a settlor's "possession or enjoyment" under §811(c) unless it effects "a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies." We add to that statement, if it can be conceived of as an addition, that it is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective. In either event the settlor has not parted with all of his presently existing or future contingent interests in the property transferred. He has therefore not made that "complete" kind of trust transfer that §811(c) commands as a prerequisite to a showing that he has certainly and irrevocably parted with his "possession or enjoyment." Any requirement less than that which we have outlined, such as a postdeath attempt to probe the settlor's thoughts in regard to the transfer, would partially impair

the effectiveness of the "possession or enjoyment" provision as an instrument to frustrate estate tax evasions. To this extent it would defeat the precise purpose for which the provision was originated and which prompted Congress to include it in §811(c). . . .

Second. It is contended that since the monetary value of the settlor's contingent reversionary interest is small in comparison with the total value of the corpus, the possession or enjoyment provision of §811(c) should not be applied. But inclusion of a trust corpus under that provision is not dependent upon the value of the reversionary interest. . . . The question is not how much is the value of a reservation, but whether after a trust transfer, considered by Congress to be a potentially dangerous tax evasion transaction, some present or contingent right or interest in the property still remains in the settlor so that full and complete title, possession or enjoyment does not absolutely pass to the beneficiaries until at or after the settlor's death.

There were forceful dissents in both cases See Bittker, "The Church and Spiegel Cases Section 811(c) Gets a New Lease on Life," 58 *Yale L. J.* 825 (1949).

As soon as the *Church* and *Spiegel* cases were decided, speculation commenced on whether *Reinecke* v. *Northern Trust Co.* had been overruled *sub silentio.** When the Supreme Court said that to avoid the postponed-possession-or-enjoyment clause, a transfer "must be unaffected by whether the grantor lives or dies," did it mean that a transfer was taxable if (as in the *Northern Trust Co.* case) the grantor's life was used as a yardstick to measure the term of a trust, even though the grantor reserved no interest for himself? Even if the Supreme Court did not intend to take this step, was there any reason to tax the trust in the *Spiegel* case which was to terminate on the grantor's death, because he would recapture the corpus in the highly unlikely event that he outlived his children and their issue, but exclude a trust that was identical in all respects except that the virtually worthless reversionary interest was vested in someone else? The impact of the *Spiegel* case on *Reinecke* v. *Northern Trust Co.* was not settled by the judiciary, however, because Congress intervened by enacting the Technical Changes Act of 1949. It has already been pointed out, *supra*, p. 1109, that this statute commenced the task of obliterating the *Church* case. It was more generous to the *Spiegel* case. For transfers after October 7, 1949, it provided that the transferred property would be included if the transferee was required to survive the transferor to obtain possession or enjoyment of the property. Thus *Reinecke* v. *Northern Trust Co* was overruled prospectively.† A transfer to trustees to accumulate the income during the settlor's life, with distribution to the son or the son's estate to be made on the settlor's death, was taxable under this part of the 1949 Act. In the case of transfers made on or before October 7, 1949, however, the 1949 Act rejected the sweeping position of the *Spiegel* case. Such transfers were not to be included in the gross estate unless the reversionary interest (a) arose by the express terms of the instrument of transfer and not by operation of law, and (b) had a value immediately before the decedent's death of more than

* It was previously argued, without success, that the Northern Trust Co. case had been overruled by implication by Hallock. Commissioner v. Lasker's Estate, 141 F.2d 889 (7th Cir. 1944).

† Reinecke v. Northern Trust Co., *supra*, pp. 1131–2, warned of a constitutional problem if Congress attempted to impose an estate tax on such transfers. In the Bullard case, *supra*, p. 1107, however, the Supreme Court said "Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax." Does this rationale dispose of the constitutional doubts expressed in the Northern Trust Co. case? Lowndes, "The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death," 3 *Vand. L. Rev.* 203 (1950).

5 per cent of the value of the transferred property. The 1949 legislation is discussed in detail in Bittker, "Church and Spiegel. The Legislative Sequel," 59 *Yale L. J.* 395 (1950); Pavenstedt, "Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel," 5 *Tax L. Rev.* 309 (1950).

In 1954, Congress intervened once more. Section 2037 of the 1954 Code preserves the 1949 rules for transfers on or before Oct. 7, 1949, but it revises the treatment of transfers made after Oct. 7, 1949. The rule of *Reinecke* v. *Northern Trust Co.* is restored, and the 5 per cent rule is extended to post-1949 transfers, except that it is applicable to interests arising by operation of law as well as to those created by the express language of the instrument of transfer. In recommending this change, the Senate Finance Committee said:

> Where the decedent has disposed of all, or substantially all, of his rights to property long before his death, it appears unduly harsh to subject the property to estate tax merely because the ultimate taker of the property is determined at the time of the decedent's death (S. Rept., p. 123.)

Is §2037(a), as amended in 1954, a sound solution to this problem? Was the 1949 legislation better? Would it be appropriate to tax only the actuarial value, just before death, of the reversionary interest?

It is interesting to note that the postponed-possession-or-enjoyment clause, for so many years the doughty workhorse of the federal estate tax law, was unceremoniously cut out of the statute in 1954. This completes the process of erosion that was begun in 1924, when the provision that is now §2038 (power to alter, amend, revoke, or terminate) first came into the law, and was hastened in 1931, when §2036 (retained life estates) was first enacted: detailed statutory language has taken over the work that the more simply phrased postponed-possession-or-enjoyment clause originally performed. The Technical Changes Act of 1949, by setting out detailed criteria for the inclusion or transfers contingent on the transferor's death, made the older clause unnecessary as to post-1949 transfers of this type. In 1954, the process was completed with the enactment of §2037, and the simpler clause could be eliminated from the statute.

COMMISSIONER v. MARSHALL'S ESTATE

U.S. Court of Appeals, Third Circuit, 1953
203 F.2d 534

Before Maris, Kalodner and Hastie, Circuit Judges.

Kalodner, Circuit Judge.

This is a petition of the Commissioner of Internal Revenue to review a decision of the Tax Court of the United States.

It poses the question whether any part of certain properties held under two trusts created [in 1931] by the settlor-decedent, Charles D. Marshall, a resident of Pennsylvania, for his wife, Dora, is includible in his gross estate under Section 811(c)(1)(C) of the [1939] Internal Revenue Code.*

* Section 811(c)(1)(C), as it stood after enactment of the Technical Changes Act of 1949, contained the postponed-possession-or-enjoyment clause, and §811(c)(2) provided that a transfer intended to take effect in possession or enjoyment at or after the transferor's death was includible (if made on or before Oct. 7, 1949) only if the decedent "retained a reversionary interest in the property, arising by the express terms of the instrument of transfer and not by operation of law, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 per centum of the value of such property." [Ed.]

The nub of the controversy is the provision in the trusts that in the event Mrs. Marshall did not exercise granted general powers of appointment the property was to go "to such person or persons as would be entitled thereto under the intestate law of the State of Pennsylvania if she had at that time died seized and possessed of the trust estate," and the fact that under the intestate law of Pennsylvania Marshall would have been entitled to one-third of his wife's estate.

The Tax Court, three judges dissenting, ruled against the inclusion of any part of the trust properties in Mr. Marshall's estate. In doing so it found facts establishing that the trusts for Mrs. Marshall were created by the decedent in consideration of and as restitution for property previously transferred by her to him and that the decedent had not by "express terms" retained a reversionary interest in the trust property and that the reversionary interest, if any, existed by reason of operation of law.

The pertinent facts may be summarized as follows:

Marshall died on May 16, 1945, while a resident of Pennsylvania. He was survived by Mrs. Marshall and six children.

On or about December 31, 1930, at Marshall's request and because he required them for business purposes, Mrs. Marshall and the six children transferred to him their second preferred stock holdings in the McClintic-Marshall Corporation. Marshall pledged he would make proper restitution for the stock to Mrs. Marshall and the children. On February 23, 1931, he made out a memorandum indicating that he owed Mrs. Marshall $347,790 — the value of the stock she had given him.

At or about that time Marshall submitted to his wife and children the texts of two trust instruments which he proposed to execute and asked them whether the provision of the trusts would be satisfactory restitution for the stock which they had transferred to him. They agreed that the trusts would be satisfactory restitution.

In March, 1931, Marshall created two trusts, for present purposes in identical terms, one-third of which was for the benefit of Mrs. Marshall and in consideration of and in restitution for her earlier stock transfer to him. The deeds of trust provided that the income from a specified part of each trust should be paid to Mrs. Marshall for life and at her death the trusts were to terminate as to those parts and the trustee was to

> . . . pay over and distribute the same in such manner and in such proportions as she shall by her last will and testament direct, limit, and appoint, and, in default of such appointment, shall pay over and distribute the same to such person or persons as would be entitled thereto under the intestate law of the State of Pennsylvania if she had at that time died seized and possessed of the trust estate.

The intestate law of Pennsylvania in effect at the time of the execution of the two trusts provided that a surviving spouse is entitled to one-third of the estate of a deceased spouse where more than one child or one child and the issue of a deceased child survive.

Mrs. Marshall, on January 26, 1943, relinquished the power of appointment given her by the trust deeds.

The fair market value of Mrs. Marshall's interest in the two trusts at the time of the transfers was $616,021.66, and at the date of the decedent's death was

$605,533.34. The value of Mrs. Marshall's life interest at the latter date was $156,972.41.

The Commissioner originally, in determining the deficiency, included in the gross estate $448,912.80 representing the value of the remainder interest after the life estate of Mrs. Marshall in the two trusts. He later revised his deficiency determination to the sum of $448,560.93 and finally, at the hearing before the Tax Court, reduced his claim to one-third of the revised sum—$149,520.31—conceding that the latter was the maximum amount which could have reverted to Marshall under the then (and present) Pennsylvania intestate law.

On this review the Commissioner contends the Tax Court erred in determining (1) the asserted reversionary interest arose by operation of law and not by express terms of the deeds of trust and (2) the indications were that Marshall was not thinking of himself and had no intention to retain a reversionary interest.

It must be noted at this point that the Commissioner does not here contend that the Tax Court erred in its finding that the trust were created in consideration of and as restitution for the $374,790 stock which Mrs. Marshall transferred to him. Accordingly, the Commissioner's claim must be taken to have been reduced (on this review) in consonance with the determined consideration under Section 811(i) of the [1939] Internal Revenue Code [§2043(a), 1954 Code] which provides that the value of the property includible must be reduced by the value of consideration received for the transfer by the settlor-decedent.

In reply to the Commissioner's contention the taxpayer asserts that the Tax Court's decision should be affirmed, not only for the reasons which it assigned in its opinion, but also because the necessary survivorship test for includibility under Section 811(c)(1)(C) is not satisfied.

Upon consideration of the record, the provisions of Section 811 and their legislative history, we are of the opinion that the Tax Court's decision should be affirmed.

First, we are in accord with the Tax Court's determination that Marshall had not by express terms retained a reversionary interest nor indicated a conscious intent to affect such a retention. Second, we are of the opinion that the necessary survivorship test for includibility was not met.

On the first score:

It would serve no useful purpose to restate here what has been so well said by the Tax Court in its opinion with reference to its determination that Marshall had not "by express terms" retained a reversionary interest. . . .

It is well-settled that words used in a statute must be considered to have been used by Congress in consonance with the common acceptance of the meaning of such words. Application of that principle to the instant case can have but one result. Section 811(c)(2) provides that "An interest in property of which the decedent made a transfer, on or before October 7, 1949, intended to take effect in possession or enjoyment at or after his death shall not be included in his gross estate . . . unless the decedent has retained a reversionary interest in the property, arising by the *express terms* of the instrument of transfer and not by operation of law. . . ." (Emphasis supplied.) The word "express" means "directly and distinctly stated; expressed, not merely implied or left to inference"; and "that is express which is worded with intention."

Clearly there was not a reservation "by express terms" in the instant case. The Commissioner does not even attempt to argue here that there was a retention of a reversionary interest by express terms. What he does say is that "The decedent, clearly had retained a *possibility* of reverter in the trust corpus." While he ignores the requirement that there must be a retention "by express terms" we, of course, cannot do so. The statute has spelled out the requirement that retention of a reverter must be "by the express terms" and "express" and "possibility" cannot be construed as synonymous by any stretch of the imagination.

On the second score:

As previously stated, the Tax Court based its decision on the fact that there had not been a retention of reverter by "express terms" and for that reason apparently did not consider it necessary to rule on the taxpayer's further contention that the transfers made by Marshall were not "intended to take effect in possession or enjoyment at or after his death" within the meaning of Section 811(c)(1)(C).

The taxpayer has asked us on this review to consider the latter question. The sum and substance of its contention in this respect is that a transfer does not come within Section 811(c)(1)(C) unless the beneficiaries must survive the decedent to obtain possession or enjoyment of the transferred interest and in the instant case if the intestate law had been changed, or if decedent had divorced or failed to support his wife, the beneficiaries could have taken the entire remainder even if they had not survived the decedent.

In our view the taxpayer is correct in its contention that the transfer was not intended to take effect in possession or enjoyment at or after the decedent's death. The "necessary survivorship" rule became part of the Treasury Regulations in 1946, when the so-called "Hallock" regulations were promulgated. Reg. 105, §81.17, T.D. 5512 (1946). As it originally appeared, the rule provided that a transfer is "intended to take effect in possession or enjoyment at or after his death," and hence the value of the transferred property is includible in the decedent's gross estate, if:

> (1) possession or enjoyment of the transferred interest can be obtained only by beneficiaries who *must* survive the decedent . . . (Emphasis supplied.)

The legislative history of the 1949 amendments to section 811(c) indicates clearly that the necessary survivorship rule was to remain undisturbed. The Senate Committee on Finance, in approving the amendments, recognized the rule,[1] and, in its discussion of the bill after it was in its final form the Conference Report states:

> . . . The existing rule that a transfer of a property interest is not intended to take effect in possession or enjoyment at or after the decedent's death unless the beneficiaries *must* survive the decedent to obtain possession or enjoyment is not disturbed. (1949-2 Cum. Bull. 295, 298; emphasis supplied.)

The . . . regulations promulgated on March 8, 1951, to implement the 1949 amendments, are to the same effect.*

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[1] 1949-2 Cum. Bull. 289, 294.

*Note that the "necessary survivorship" rule is now set out in §2037(a)(1) of the 1954 Code; from 1949 to 1954, it appeared in §811(c)(3), dealing with transfers after Oct. 7, 1949, but not in §811(c)(2), dealing with transfers on or before Oct. 7, 1949. [Ed.]

Undoubtedly then, in determining whether a transferred interest which might revert back to the settlor-decedent was intended to take effect in possession or enjoyment at or after his death, we must inquire whether it was possible, immediately prior thereto for some person who need not have survived him to take that interest. Or, otherwise stated, we must determine whether there was any other contingency, besides the settlor-decedent's death, upon the happening of which his reverter interest would be entirely cut off. If there was, and that contingency was "real," then the transfer was not intended to take effect in possession and enjoyment at or after his death.

At the moment preceding Marshall's death it was possible for beneficiaries to take the one-third interest without surviving him. This could have resulted (1) by a change in the intestate laws of Pennsylvania, mitigating or eliminating the surviving spouse's share; (2) under the present intestate laws if Marshall had divorced his wife or she had divorced him, (3) if Marshall either wilfully neglected or refused to provide for Mrs. Marshall for one year previous to her death, or if he wilfully and maliciously had deserted her for that period. Had any one of those things occurred, the one-third interest which decedent would otherwise have gotten, would have gone to persons (the children, if they survived their mother) who would not have had to survive the decedent.

Nor can these contingencies be disregarded on the ground that they are "unreal." [2] They cannot be regarded as "sham," [3] for, as the Tax Court said:

> The indications are that the decedent was not thinking of himself or intending to provide that a part of the trust property was to revert to him and was not to pass to others save upon the condition that he predeceased his wife . . . It seems unlikely that he had it in mind.

The possible contingencies taken together under which beneficiaries could have taken the interest without surviving Marshall cannot be regarded as so remote as to be "unreal."

Thus, there being another event (or events) upon which the beneficiaries could have taken the one-third interest without surviving the decedent, the transfer was not "intended to take effect in possession or enjoyment at or after his (Marshall's) death" and is therefore not includible in Marshall's gross estate.

For the reasons stated the discussion of the Tax Court will be affirmed.

Note

1. Another type of transfer that does not satisfy the "necessary survivorship" rule laid down in the "Hallock regulation" and now set out in §2037(a)(1) of the 1954

[2] The 1951 Hallock regulations state:

"Where possession or enjoyment of the transferred property can be obtained either by surviving the decedent or through the occurrence of some other event . . . the transfer shall not be considered as intended to take effect in possession or enjoyment at or after the decedent's death *unless, from a consideration of its terms and circumstances as a whole, the other event is deemed to be unreal, in which case such other event shall be disregarded.*" (Emphasis supplied.)

[3] Bittker, in his article "Church and Spiegel: The Legislative Sequel," 59 *Yale L. J.* 395, 404 (1950), gives the following example of the "unreal" event; ". . . suppose the remainderman were a member of the Communist Party and could take either by becoming President of Yale University or by surviving the settlor. Under the 'Hallock regulation' no doubt the 'other event' would be unreal."

Code is this: income to the settlor's wife for her life, remainder to their surviving issue, with a reversion to the settlor or his estate if no issue survive the wife. The "Hallock regulation" did not treat this as a transfer intended to take effect in possession or enjoyment at or after the decedent's death, because the children will take if and only if they are alive when the *life tenant* dies, whether the settlor is still alive or not. Their rights, in other words, are not affected by the settlor's death: if he dies the day after the trust is created, they are no closer to possession or enjoyment than if he were still alive. Similarly, the transfer is not within the scope of §2037(a)(1), because that clause reaches only those transfers under which "possession or enjoyment of the property can . . . be obtained *only* by surviving the decedent."

During the period from 1940, when the *Hallock* case was decided, to 1946, when the "Hallock regulation" was promulgated, however, a few courts adopted the view that *any* reversionary interest in the settlor required the entire corpus to be included in the gross estate, although the statute said nothing of reversionary interests *per se*. When this uncritical preoccupation with reversionary interests was at its height, the government seemed to be ready to find a reversionary interest in any trust: if there was a final gift over to a related beneficiary and his estate, it was suggested that the grantor might get the property back by inheritance; if the remainder was left to a charity, it was suggested that the designated charity might not be in existence and that the *cy pres* doctrine would not be applied, so that the property could revert to the grantor; if the final gift was to the United States (in the hope that no government representative would have the temerity to argue that it might be non-existent when the remainder was to fall in), the gift might be declined because the estate tax would be larger in amount than the remainder, thus causing a reversion to the grantor, *etc.* See Looker, "Estate Taxation of Living Trusts: The Church and Spiegel Decisions," 49 *Col. L. Rev.* 437, 447 *ff* (1949). One state intervened (though not until 1949) in aid of the nervous settlor by providing that "if by the terms of the controlling trust instrument the settlor manifested irrevocably his intention to divest himself of all interest" in the property, any interest which otherwise "would be recognized in the settlor of the trust or the estate of the settlor or the heirs at law of the settlor as such . . . shall be deemed to be held upon a resulting trust for the State of Minnesota." Ch. 201, Minn. Laws of 1949.

Most of the remote reversionary interests that could arise upon failure of issue, dissolution of charities, *etc.* were not conditioned on survivorship at all, and the fears of cautious conveyancers were calmed when in 1946 the "Hallock regulation" recognized that the only statutory significance of a reversionary interest was that it *might* postpone the beneficiary's possession or enjoyment until the settlor's death. Under this regulation, a reversionary interest was fatal only if it was conditioned on survivorship. Platt, "The New Hallock Regulation," 2 *Tax L. Rev.* 94 (1946). Other reversionary interests were includible in the gross estate under §2033, if not extinguished at death, but only to the extent of their value at the time of death.

When the Supreme Court in the *Church* and *Spiegel* cases stated (*supra*, p. 1137) that a transfer could not escape the postponed-possession-or-enjoyment clause unless the settlor is left with "no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter," however, it reopened the possibility that any reversionary interest might require inclusion of the entire value of the transferred property. But this possibility was promptly foreclosed by the Technical Changes Act of 1949, which adopted the "necessary survivorship" test of the "Hallock regulation," and this requirement is carried forward by §2037(a)(1).

The transfer described at the beginning of this note, therefore, would not be taxable under §2037. But if the settlor dies before his wife, his estate will possess a possibility of acquiring the property: if when the wife dies no issue survive her, the property will revert to the settlor's estate. The value of this possibility—not the value of the entire corpus—will be included in the settlor's estate under §2033.

2. The children (and the descendants of deceased children) in the *Marshall's Estate* case could have taken the one-third that was in dispute, provided they survived Mrs.

Marshall, under either of two alternative contingencies: (a) if they survived Mr. Marshall, or (b) if Mr. Marshall's interest was cut off by legislation, divorce, or non-support. The transfer under review was made before 1949. Under the Technical Changes Act of 1949, a transfer *after* Oct. 7, 1949, was taxable if alternative contingencies were provided by the instrument of transfer and if the "other event" did not in fact occur during the decedent's life. But for transfers *on or before* Oct. 7, 1949, as the case indicates, the Technical Changes Act of 1949 apparently adopted the view of the "Hallock regulation" that the property is includible only if the other event is "unreal." Since the 1954 Code put post-1949 transfers on a par with pre-1949 transfers (except that post-1949 reversionary interests by operation of law are not exempt), presumably the "Hallock regulation's" view of alternative contingencies (*supra*, p. 143, n. 2) is carried forward.

3. Note that when the trusts were created, Mrs. Marshall was given the power to appoint the corpus; but since in 1943 she released the power, its legal effect was not in issue. Had she not released the power of appointment, the children would have been able to obtain possession and enjoyment of the property if their mother exercised her power of appointment in their favor. If a beneficiary or third party has the power to cut off the decedent's reversionary interest by exercising a general power of appointment, the decedent's death cannot be realistically regarded as a necessary condition to possession or enjoyment. But the Supreme Court held in *Goldstone* v. *United States*, 325 U.S. 687 (1945), that at least in some circumstances a reversionary interest was to be counted against the settlor even if it could be destroyed by a beneficiary's power of appointment, and the last sentence of §2037(b) rejects the Court's approach. See Bittker, "Church and Spiegel· The Legislative Sequel," 59 *Yale L. J.* 395, 406–410 (1950). Mrs. Marshall's power was exercisable only by will (16 T.C. at 919), and would probably not have met the standards of the last sentence of §2037(b). But if the grantor's reversionary interest can be destroyed by the exercise of a power of appointment, even if the power does not meet the statutory standard, is the "necessary survivorship" rule of §2037(a)(1) satisfied?

4. Even if both questions in the *Marshall's Estate* case had been answered adversely to the taxpayer, it would still have been necessary to determine if the value of the reversionary interest immediately before the death of the decedent exceeded 5 per cent of the value of the property. The ages of Mr. and Mrs. Marshall are not given in the reports, and this information would be essential in determining if his chance of surviving his wife was worth more than 5 per cent of $150,000. If Mrs. Marshall had not relinquished her power to appoint the property by will, would it have been possible to place a value on Mr. Marshall's interest? For more on the problem of valuing reversionary interests, see *infra*, pp. 1151–2.

5. If the grantor of a trust finds that he possesses a reversionary interest that may be worth more than 5 per cent of the corpus when he dies, would a release or assignment of the unwanted interest during his lifetime be a gift in contemplation of death? If so, is the value of the entire corpus includible or only the value of the interest? This problem was considered earlier in connection with a release of a retained life estate to avoid the estate tax. *Supra*, pp. 1117–8.

Gift Tax

SMITH v. SHAUGHNESSY

Supreme Court of the United States, 1943
318 U.S. 176

Mr. Justice Black delivered the opinion of the Court.

The question here is the extent of the petitioner's liability for a tax under

§§501, 506 of the Revenue Act of 1932 [§2511(a), 1954 Code], which imposes a tax upon every transfer of property by gift, "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; . . ."

The petitioner, age 72, made an irrevocable transfer in trust of 3,000 shares of stock worth $571,000. The trust income was payable to his wife, age 44, for life; upon her death, the stock was to be returned to the petitioner, if he was living, if he was not living, it was to go to such persons as his wife might designate by will, or in default of a will by her, to her intestate successors under applicable New York law. The petitioner, under protest, paid a gift tax of $71,674 22, assessed on the total value of the trust principal, and brought suit for refund in the district court. Holding that the petitioner had, within the meaning of the Act, executed a completed gift of a life estate to his wife, the court sustained the Commissioner's assessment on $322,423, the determined value of her life interest; but the remainder was held not to be completely transferred and hence not subject to the gift tax. 40 F.Supp. 10. The Government appealed and the Circuit Court of Appeals reversed, ordering dismissal of the petitioner's complaint on the authority of its previous decision in *Herzog* v. *Commissioner*, 116 F.2d 591. We granted certiorari because of alleged conflict with our decisions in *Helvering* v. *Hallock*, 309 U.S. 106, and *Sanford* v. *Commissioner*, 308 U.S. 39.* In these decisions, and in *Burnet* v. *Guggenheim*, 288 U.S. 280,† we have considered the problems raised here in some detail, and it will therefore be unnecessary to make any elaborate re-survey of the law.

Three interests are involved here: the life estate, the remainder, and the reversion. The taxpayer concedes that the life estate is subject to the gift tax. The Government concedes that the right of reversion to the donor in case he outlives his wife is an interest having value which can be calculated by an actuarial device, and that it is immune from the gift tax. The controversy, then, reduces itself to the question of the taxability of the remainder.

The taxpayer's principal argument here is that under our decision in the *Hallock* case, the value of the remainder will be included in the grantor's gross estate for estate tax purposes; and that in the *Sanford* case we intimated a general policy against allowing the same property to be taxed both as an estate and as a gift.

This view, we think, misunderstands our position in the *Sanford* case. As we said there, the gift and estate tax laws are closely related and the gift tax serves to supplement the estate tax.[1] We said that the taxes are not "always mutually exclusive," and called attention to §322 of the 1924 Act there involved (reenacted with amendments in §801 of the 1932 Act) ‡ which charts the course for granting

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* *Supra*, p. 1133 and p. 1073. [Ed.]

† *Supra*, p. 913. [Ed.]

[1] The gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates. House Report No. 708, 72d Cong., 1st Sess., p. 28, Brandeis, J., dissenting in Untermyer v. Anderson, 276 U.S. 440, 450; Stone, J., dissenting in Heiner v. Donnan, 285 U.S. 312, 333.

‡ The gift tax credit is now to be found in §2012; see *infra*, p. 1230. [Ed.]

credits on estate taxes by reason of previous payment of gift taxes on the same property. The scope of that provision we need not now determine. It is sufficient to note here that Congress plainly pointed out that "some" of the "total gifts subject to gift taxes . . . may be included for estate tax purposes and some not." House Report No. 708, 72d Cong., 1st Sess., p. 45. Under the statute the gift tax amounts in some instances to a security, a form of down-payment on the estate tax which secures the eventual payment of the latter; it is in no sense double taxation as the taxpayer suggests.

We conclude that under the present statute, Congress has provided as its plan for integrating the estate and gift taxes this system of secured payment on gifts which will later be subject to the estate tax [2]

Unencumbered by any notion of policy against subjecting this transaction to both estate and gift taxes, we turn to the basic question of whether there was a gift of the remainder. The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.

We cannot accept any suggestion that the complexity of a property interest created by a trust can serve to defeat a tax. For many years Congress has sought vigorously to close tax loopholes against ingenious trust instruments. Even though these concepts of property and value may be slippery and elusive they can not escape taxation so long as they are used in the world of business. The language of the gift tax statute, "property . . . real or personal, tangible or intangible," is broad enough to include property, however conceptual or contingent. And lest there be any doubt as to the amplitude of their purpose, the Senate and House Committees, reporting the bill, spelled out their meaning as follows:

> The terms "property," "transfer," "gift," and "indirectly" [in §501], are used in the broadest and most comprehensive sense, the term "property" reaching every species of right or interest protected by law and having an exchangeable value.[3]

The Treasury regulations, which we think carry out the Act's purpose, made specific provisions for application of the tax to, and determination of the value of, "a remainder . . . subject to an outstanding life estate." [4]

The essence of a gift by trust is the abandonment of control over the property put in trust. The separable interests transferred are not gifts to the extent that power remains to revoke the trust or recapture the property represented by any of them, *Burnet* v. *Guggenheim*, *supra*, or to modify the terms of the arrangement so as to make other disposition of the property, *Sanford* v. *Commissioner*,

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[2] It has been suggested that the congressional plan relating the estate and gift taxes may still be incomplete. See *e.g.*, Griswold, "A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions, *etc.*," 56 *Harv. L. Rev.* 337; Magill, "The Federal Gift Tax," 40 *Col L. Rev.* 773, 792, Kauper, "The Revenue Act of 1942: Estate and Gift Tax Amendments," 41 *Mich. L. Rev.* 369, 388; and see Commissioner v. Prouty, 115 F.2d 331, 337; Higgins v. Commissioner, 129 F.2d 237, 239.

[3] Senate Report No. 665, 72d Cong., 1st Sess., p. 39, House Report No. 708, *supra*, p. 27.

[4] Treas. Regulations 79 (1936 Ed.), Arts. 2, 3, 17, 19. *Cf.* Commissioner v. Marshall, 125 F.2d 943, 945.

supra. In the *Sanford* case the grantor could, by modification of the trust, extinguish the donee's interest at any instant he chose. In cases such as this, where the grantor has neither the form nor substance of control and never will have unless he outlives his wife, we must conclude that he has lost all "economic control" and that the gift is complete except for the value of his reversionary interest.

The judgment of the Circuit Court of Appeals is affirmed with leave to the petitioner to apply for modification of its mandate in order that the value of the petitioner's reversionary interest may be determined and excluded.

It is so ordered.

MR. JUSTICE ROBERTS.

I dissent. I am of opinion that, except for the life estate in the wife, the gift *qua* the donor was incomplete and not within the sweep of §§501 and 506. A contrary conclusion might well be reached were it not for *Helvering* v. *Hallock*, 309 U.S. 106. But the decisions in *Burnet* v. *Guggenheim*, 288 U.S. 280, and *Sanford* v. *Commissioner*, 308 U.S. 39, to which the court adheres, require a reversal in view of the ruling in the *Hallock* case.

The first of the two cases ruled that a transfer, in trust whereby the grantor reserved a power of revocation, was not subject to a gift tax, but became so upon the renunciation of the power. The second held that where the grantor reserved a power to change the beneficiaries, but none to revoke or to make himself a beneficiary, the transfer was incomplete and not subject to gift tax. At the same term, in *Porter* v. *Commissioner*, 288 U.S. 436, the court held that where a decedent had given property *inter vivos* in trust, reserving a power to change the beneficiaries but no power to revoke or revest the property in himself, the transfer was incomplete until the termination of the reserved power by the donor's death and hence the corpus was subject to the estate tax.

When these cases were decided, the law, as announced by this court, was that where, in a complete and final transfer *inter vivos*, a grantor provided that, in a specified contingency, the corpus should pass to him, if living, but, if he should be dead, then to others, the gift was complete when made, he retained nothing which passed from him at his death, prior to the happening of the contingency, and that no part of the property given was includible in his gross estate for estate tax. *McCormick* v. *Burnet*, 283 U.S. 784; *Helvering* v. *St. Louis Union Trust Co.*, 296 U.S. 39; *Becker* v. *St. Louis Union Trust Co.*, 296 U. S. 48. So long as this was the law the transfer might properly be the subject of a gift tax for the gift was, as respects the donor, complete when made.

In 1940 these decisions were overruled and it was held that such a transfer was so incomplete when made, and the grantor retained such an interest, that the cessation of that interest at death furnished the occasion for imposing an estate tax. Thus the situation here presented was placed in the same category as those where the grantor had reserved a power to revoke or a power to change beneficiaries. By analogy to the *Guggenheim* and *Sanford* cases, I suppose the gift would have become complete if the donor had, in his life, relinquished or conveyed the contingent estate reserved to him.

In the light of this history, the *Sanford* case requires a holding that the gifts in

remainder, after the life estate, create no gift tax liability. The reasoning of that decision, the authorities, and the legislative history relied upon, are all at war with the result in this case. There is no need to quote what was there said. A reading of the decision will demonstrate that, if the principles there announced are here observed, the gifts in question are incomplete and cannot be the subject of the gift tax.

It will not square with logic to say that where the donor reserves the right to change beneficiaries, and so delays completion of the gift until his death or prior relinquishment of the right, the gift is incomplete, but where he reserves a contingent interest to himself the reverse is true,—particularly so, if the criterion of estate tax liability is important to the decision of the question, as the *Sanford* case affirms.

The question is not whether a gift which includes vested and contingent future interests in others than the donor is taxable as an entirety when made, but whether a reservation of such an interest in the donor negatives a completion of the gift until such time as that interest is relinquished.

All that is said in the *Sanford* case about the difficulties of administration and probable inequities of a contrary decision there, applies here with greater force. Indeed a system of taxation which requires valuation of the donor's retained interest, in the light of the contingencies involved, and calculation of the value of the subsequent remainders by resort to higher mathematics beyond the ken of the taxpayer, exhibits the artificiality of the Government's application of the Act. This is well illustrated in the companion cases of *Robinette* and *Paumgarten*, *infra*, p. 184. Such results argue strongly against the construction which the court adopts.

ROBINETTE v. HELVERING

Supreme Court of the United States, 1943
318 U.S. 184

MR. JUSTICE BLACK delivered the opinion of the Court.

This is another case under the gift tax provisions of the Revenue Act of 1932, §§501, 506, which, while presenting certain variants on the questions decided in *Smith* v. *Shaughnessy*, *ante*, p. 176, is in other respects analogous to and controlled by that case.

In 1936, the petitioner, Elise Paumgarten (nee Robinson), was thirty years of age and was contemplating marriage; her mother, Meta Biddle Robinette, was 55 years of age and was married to the stepfather of Miss Robinson. The three, daughter, mother and stepfather, had a conference with the family attorney, with a view of keeping the daughter's fortune within the family. An agreement was made that the daughter should place her property in trust, receiving a life estate in the income for herself, and creating a second life estate in the income for her mother and stepfather if she should predecease them. The remainder was to go to her issue upon their reaching the age of 21, with the further arrangement for the distribution of the property by the will of the last surviving life tenant if no issue existed. Her mother created a similar trust, reserving a life

estate to herself and her husband and a second or contingent life estate to her daughter. She also assigned the remainder to the daughter's issue. The stepfather made a similar arrangement by will. The mother placed $193,000 worth of property in the trust she created, and the daughter did likewise with $680,000 worth of property.

The parties agree that the secondary life estates in the income are taxable gifts, and this tax has been paid. The issue is whether there has also been a taxable gift of the remainders of the two trusts. The Commissioner determined that the remainders were taxable, the Board of Tax Appeals reversed the Commissioner, and the Circuit Court of Appeals reversed the Board of Tax Appeals. 129 F.2d 832.

The petitioners argue that the grantors have not relinquished economic control and that this transaction should not be subject both to the estate and to the gift tax. What we have said in the *Smith* case determines these questions adversely to the petitioners. However, the petitioners emphasize certain other special considerations.

First. Petitioners argue that since there were no donees in existence on the date of the creation of the trust who could accept the remainders, the transfers cannot be completed gifts. The gift tax law itself has no such qualifications. It imposes a tax "upon the transfer . . . of property by gift." And Treasury Regulations 79, Art. 3, provide that "The tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable." We are asked to strike down this regulation as being invalid because inconsistent with the statute. We do not think it is. As pointed out in the *Smith* case, the effort of Congress was to reach every kind and type of transfer by gift. The statute "is aimed at transfers of the title that have the quality of a gift." *Burnet* v. *Guggenheim,* 288 U.S. 280, 286. The instruments created by these grantors purported on their face wholly to divest the grantors of all dominion over the property, it could not be returned to them except because of contingencies beyond their control. Gifts of future interests are taxable under the Act, §504(b), and they do not lose this quality merely because of the indefiniteness of the eventual recipient. The petitioners purported to give the property to someone whose identity could be later ascertained and this was enough.

Second. It is argued that the transfers were not gifts but were supported by "full consideration in money or money's worth." This contention rests on the assumption that an agreement between the parties to execute these trusts was sufficient consideration to support the transfers. We need not consider or attempt to decide what were the rights of these parties as among themselves. Petitioners think that their transaction comes within the permissive scope of Art. 8 of Regulations 79 (1936 edition) which provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth." The basic premise of petitioner's argument is that the moving impulse for the trust transaction was a desire to pass the family fortune on to others.

It is impossible to conceive of this as even approaching a transaction "in the ordinary course of business."

Third. The last argument is that "in any event, in computing the value of the remainders herein, allowance should be made for the value of the grantor's reversionary interest." Here, unlike the *Smith* case, the government does not concede that the reversionary interest of the petitioner should be deducted from the total value. In the *Smith* case, the grantor had a reversionary interest which depended only upon his surviving his wife, and the Government conceded that the value was therefore capable of ascertainment by recognized actuarial methods. In this case, however, the reversionary interest of the grantor depends not alone upon the possibility of survivorship but also upon the death of the daughter without issue who should reach the age of 21 years. The petitioner does not refer us to any recognized method by which it would be possible to determine the value of such a contingent reversionary remainder. It may be true, as the petitioners argue, that trust instruments such as these before us frequently create "a complex aggregate of rights, privileges, powers and immunities and that in certain instances all these rights, privileges, powers and immunities are not transferred or released simultaneously." But before one who gives his property away by this method is entitled to deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds. Factors to be considered in fixing the value of this contingent reservation as of the date of the gift would have included consideration of whether or not the daughter would marry; whether she would have children; whether they would reach the age of 21; *etc.* Actuarial science may have made great strides in appraising the value of that which seems to be unappraisable, but we have no reason to believe from this record that even the actuarial art could do more than guess at the value here in question. *Humes* v. *United States*, 276 U.S. 487, 494.

The judgment of the Circuit Court of Appeals is affirmed.

Mr. Justice Roberts dissents for the reasons set forth in his opinion in *Smith* v. *Shaughnessy*, *ante*, p. 176.

Note

1. Section 2037(b) of the estate tax law states that in applying the 5 per cent test, the value of a reversionary interest shall be determined "by usual methods of valuation, including the use of tables of mortality and actuarial principles." The Conference Committee's report on the Technical Changes Act of 1949, in recommending adoption of the 5 per cent rule, stated.

> The value [of a reversionary interest] shall be ascertained as though the decedent were, immediately before his death, making a gift of the property and retaining the reversionary interest. The rule of *Robinette* v. *Helvering* (318 U.S. 184), under which a reversionary interest not having an ascertainable value under recognized valuation principles is considered to have a value of zero, is to apply. (H. Rept. No. 1412, 81st Cong., 1st sess., 49-2 C.B 295, 297.)

Why should valuation of reversionary interests, under the 5 per cent rule, be governed by the same principles that are applied in valuing such interests for the gift tax?

The Senate Report on the 1954 Code states:

> The decedent's reversionary interest is to be valued by recognized valuation

> principles and without regard to the fact of the decedent's death. Where it is apparent from the facts that property could have reverted to the decedent under contingencies that were not remote, the reversionary interest is not to be necessarily regarded as having no value merely because the value thereof cannot be measured precisely.* (S. Rept. No. 1622, 83rd Cong., 2d sess., p. 469.)

If the reversionary interest's value cannot be determined by recognized principles of valuation, is it to be treated as having no value, as the 1949 Conference Report states, —or does the 1954 Senate Report mean that it will be treated as worth more than 5 per cent because the taxpayer will be unable to prove that it is worth less? In *Estate of Thacher* v. *Commissioner*, 20 T.C. 474 (1953), property would revert to the decedent if his wife was divorced or legally separated from him. Because there was no evidence that the value of the reversionary interest could not be measured, the Court held that it had to assume that the value of the interest exceeded 5 per cent of the value of the property. Can this conclusion be reconciled with the 1949 Conference Report? The case was decided in 1953. If it had come up after the 1954 Senate Report, would the reversionary interest be fatal even if there was evidence that its value could not be calculated by recognized valuation methods? If the wife in the *Marshall's Estate* case, *supra*, p. 1139, had not released her power to appoint the property by will, could the husband's reversionary interest have been valued? Suppose the court in that case had thought that the contingencies there discussed (divorce, non-support, and statutory change) *were* "unreal." If they could occur, and there is no way to measure their likelihood, would the 5 per cent rule be satisfied? If the value of a reversionary interest cannot be calculated by recognized principles, does it matter that the event was to some degree subject to the decedent's control (*e.g.*, his divorce, remarriage, *etc.*)?

2. What is the relation between the 5 per cent rule and cases like *Blunt* v. *Kelly*, *supra*, p. 1086. Under these cases, part of all of the corpus of a trust may be taxable in the grantor's estate if he has the right to compel the trustee to make distributions when specified circumstances arise. If the possibility is such that the 5 per cent rule would not be satisfied, are these cases (which arose under the old postponed-possession-or enjoyment clause) still valid?

3. *Harrison* v. *Commissioner*, 17 T.C. 1350 (1952), involved the valuation, for gift tax purposes, of a trust under which the trustee was required to pay the settlor's federal and state income taxes. The Commissioner contended that in computing the amount subject to gift tax no allowance could be made for the settlor's reservation of the right to have her income taxes paid by the trustee becaue the value of that right was not ascertainable with the accuracy required by the *Robinette* case. The court held:

> It is, of course, impossible to foretell with mathematical accuracy the amount of the future Federal and state income taxes which have to be paid under the terms of the trust agreement within the lifetime of petitioner. However, of a certainty, we know that some tax payments will be required Since the adoption of the Sixteenth Amendment to the Constitution, Federal income taxes have become a permanent and growing part of our economy, and there is no likelihood that such taxes will not continue to be imposed throughout the life expectancy of petitioner. Even though difficult to ascertain, an estimate of petitioner's present right to have her future income tax paid should be made. (17 T.C. at 1354–5.)

An estimate was more feasible in the *Harrison* case than it would be in many circumstances, since the taxpayer had transferred all of her income-producing property into

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* In *Summary of the New Provisions of the Internal Revenue Code of 1954* (1955), prepared by the Joint Committee on Internal Revenue Taxation, the 5 per cent rule is described as follows: "The 1954 Code provides that property previously transferred by a decedent is to be includible in his estate only if he still has (either expressly or by operation of law) immediately before his death a reversionary interest in the property exceeding 5 per cent of its value. The reversionary interest will be valued by actuarial methods so that a mere expectancy will have no value, whether or not it could be considered a reversionary interest." (P. 113.)

the trust and had retained only the right to receive $12,000 per year therefrom (plus an amount to discharge her income taxes); the value of the right to have her income taxes paid was apparently estimated by the court on the assumption that federal and state taxes would continue for the settlor's life expectancy to be very nearly what they were when the trust was created. (For another aspect of this case, see *supra*, p. 919.)

In *Lingo* v. *Commissioner*, ¶54,144 P-H Memo TC (1954), the court had to pass on the gift tax value of a trust under which the settlor had reserved the right to the income until her death or remarriage. Her claim was that the value of the trust should be reduced by the value of the income for her life, on the ground that by not remarrying she could enjoy the income for that period. She apparently made no effort to establish the value of the right to receive the income until her remarriage, although the courts have on several occasions accepted the validity of actuarial computations of the likelihood of remarriage. See *Commissioner* v. *Maresi*, 156 F.2d 929 (2d Cir. 1946); *supra*, p. 931.

REVENUE RULING 54-538

Internal Revenue Service, 1954
1954-2 C.B. 316

Advice is requested relative to the extent to which the Internal Revenue Service will follow the decision in *Christianna K. Gramm* v. *Commissioner*, 17 T.C. 1063, acquiescence C.B. 1952-1, 2, in a situation where a donor conveys all of his income-producing property in trust directing that the trustee is to pay to the donor such portion of the income and corpus as the trustee in its sole discretion shall deem necessary for the support of the donor during his life and upon the donor's death to distribute the corpus and accumulated income to his children, per stirpes.

In the case of *Christianna K. Gramm* v. *Commisioner*, *supra*, the donor created a trust of all of her property having a value of $83,000, reserving the income to herself for life. The corporate trustee was authorized to invade the corpus for the comfort, education, maintenance or support of the donor. In holding that no completed gift was made, the Tax Court said, in part:

> Sums which decedent might have required for her "comfort," for example, were incapable of determination or calculation at the time of the creation of the trust. The corpus was in medium amount (about $83,000) so that it was possible the corporate trustee would have to invade the corpus for her benefit. Numerous situations can be imagined where such would be done for decedent's "comfort," such as the purchase of a house in which she might live, the necessity of moving to a different climate because of her health, or illness entailing large expenses for doctors, nurses, hospitals.

It is the position of the Internal Revenue Service that the decision of the Tax Court holding the entire gift incomplete was based on the assumption that in view of the small amount of corpus and the resulting small annual income, substantial invasion of the corpus was very probable and, accordingly, the decision is not contrary to the decisions in *Hurlburt W. Smith* v. *Shaughnessy*, 318 U.S. 176, Ct. D. 1575, C.B. 1943, 1144, and *Meta Biddle Robinette, et al.* v. *Helvering*, 318 U.S. 184, Ct. D. 1574, C.B. 1943, 1141. The law of those cases is that where a donor transfers property retaining a reversionary interest which is capable of valuation by recognized actuarial methods, the value of the retained interest should be excluded from the gift, but where the value of the reversionary interest

is not susceptible of valuation by recognized actuarial methods, the entire gift is complete. In the *Gramm* case the court said that such sums which the donor might have requested for her "comfort" were incapable of determination or calculation at the time of the creation of the trust.

There is no indication that the court intended that its decision in the case of *Christianna K. Gramm* v. *Commissioner, supra,* should be considered to be in conflict with the decided cases. The decision, though seemingly contrary to decided cases, should be viewed in the light of the unusual and particular facts in the case. The acquiescence is limited to the law as applied to the facts found by the Tax Court.

In view of the foregoing, it is held that a gift in trust is not rendered wholly incomplete merely because the trustee is authorized to use income and corpus, if necessary, for the donor's support in a case where a donor conveys all of his income-producing property in trust directing the trustee to pay the donor such portion of the income and corpus as the trustee in its sole discretion shall deem necessary for the support of the donor during his life and upon the donor's death to distribute the corpus and accumulated income to his children, per stirpes. The amount required annually for the donor's support according to his accustomed mode of living may be ascertained and valued as an annuity. See *Ithaca Trust Co.* v. *United States,* 279 U.S. 151, Ct. D. 59, C.B. VIII-1,313; and *Blodgett et al.* v. *Delaney,* 201 Fed.(2d) 589. The value of the gift is the value of the transferred property less the value of the donor's retained support rights.

FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX

Joint Study of Advisory Committee to the Treasury Department and by Office of Tax Legislative Counsel, 1947, pp. 22–24

2. *Dispositions Reserving a Reversionary Interest in the Transferor*

Under this heading the following provisions are recommended:

(a) A transfer shall be deemed incomplete if the property or the income therefrom must revert to the transferor or his estate after the expiration of any period of time;

(b) A transfer shall be deemed incomplete if the property or the income therefrom may so revert to the transferor or his estate and no beneficiary can obtain possession or enjoyment of the property during the transferor's lifetime.

These suggestions for change require a brief explanation of existing law.

If a transferor at the present time [1947], in making an *inter vivos* disposition of property, provides that the property is to return to him or his estate after a specified period of time, a gift tax is imposed upon the value of the interests granted to others. If the property does not revert to him prior to his death, an estate tax is imposed upon the value of the reversion at the date of death. If there is a similar reversionary interest only in the income, the actuarial value of

such lesser interest is taxable at death. The draft accompanying this report would withhold the imposition of any transfer tax until death unless the reversionary interest were released before death. There are two reasons which suggest the appropriateness of the recommendations. First, a transfer tax should strive as much as possible, for the sake of simplicity in application and convenience of administration, to apply at one particular time to a disposition as a whole. One might say that such single application is of the very essence of an integrated transfer tax. If tax is imposed at several stages, difficulties are bound to arise, especially with regard to the valuation of interests preceding the reversion. Secondly, the recommendation follows very naturally from the income tax treatment proposed with respect to the same type of transfer. Since it was felt that income tax should be imposed upon the transferor, a suggestion that such a transfer be treated as a completed gift was rejected. The considerations for imposition of income tax upon the transferor in this connection are noted more fully below in describing the income tax recommendations.

A problem of much greater importance under the existing estate and gift taxes is presented by a reversionary interest in the grantor or his estate which is contingent in character. Such an interest arises where the property may or may not return to the grantor, depending upon whether or not he survives the income beneficiaries. The gift tax consequences where such a reversionary interest is present are generally clear. A gift tax is payable upon the value of the entire property less the value of the reversionary interest (*Smith* v. *Shaughnessy*, 318 U.S. 176 (1943)), or upon the value of the entire property if the reversionary interest cannot be valued according to recognized actuarial methods of computation (*Robinette* v. *Helvering*, 318 U.S. 184 (1943)). If the property is thereafter included in the gross estate at the transferor's death, a credit is allowed for the gift tax paid.

The situation under the estate tax was obscure for a long time. The recent regulations have, however, cleared the air of much of the confusion surrounding transfers with reserved reversionary interests. See Reg. 105, section 81.17. Under the regulations, if a transferor provides that the property is to return to him if he is living at the death of the income beneficiaries, the value of the property, less the value of any outstanding life estates in others, is includible in the gross estate. The typical situation is one in which the transferor provides for a life estate in his wife, a remainder to their children if he predeceases his wife, and a reversion to him if he survives her. Inasmuch as the ultimate receipt of the remainder is dependent upon the beneficiaries' survival of the transferor, it is taxable under section 811(c)* as a transfer intended to take effect in possession or enjoyment at or after the transferor's death. *Helvering* v. *Hallock*, 309 U.S. 106 (1940). On the other hand, where the passing of a remainder interest is not dependent upon the transferor's death, such interest is not subjected by the regulations to an estate tax despite the transferor's reservation of a reversion. Such a case may be illustrated by a transfer in trust providing for a life estate in the transferor's wife, a remainder to their surviving issue, and a reversion to the transferor or his estate in the absence of such issue.

* *I.e.*, before the 5 per cent rule was enacted by the Technical Changes Act of 1949. [Ed.]

The foregoing principles have provided the basis for the recommendation made with respect to contingent reversionary interests. Under the proposed provision, where the transferor reserves such an interest, the basic question is whether any beneficiary can obtain possession or enjoyment of the property during the transferor's lifetime. If the answer is in the affirmative, the entire property is subjected to transfer tax at the time of transfer. If the answer is in the negative, the transfer tax is postponed until death. In neither case is allowance made for the value of the reversion or of any outstanding life estates. In this manner there is but one taxable event and difficult problems of valuing "slippery and elusive" interests are avoided. *Cf. Smith* v. *Shaughnessy*, 318 U.S. 176, 180 (1943). Although such problems could be avoided by treating all transfers with contingent reversionary interests as completed gifts, this approach was rejected for two reasons. First, since transfers of the *Hallock* variety suspend the ultimate possession of the property until the grantor's death, they are essentially death transfers of the property. Secondly, the adoption of such a rule would create an avenue of income tax avoidance through the use of contingent reverters which would almost certainly vest in the grantor prior to death. On the other hand, dispositions under which the property can be obtained while the transferor is living do not constitute dispositions at death and are accordingly treated as completed transfers. It is of course possible, as in the case of a *Hallock* transfer, to utilize such a disposition as a means of escaping the income tax on the transferred property and at the same time assuring the return of the property. The fact that a second transfer tax on the entire property would be payable when the transferor redisposes of the property which has come back to him, however, will tend to discourage such devices.

Note

How does this proposal differ from the treatment provided by the 1954 Code? Which is preferable, in your opinion?

Section G. Survivorship Annuities: Section 2039

1. *Purchased Commercial Annuities*

Section 2039, governing the taxability of survivorship annuities, was added to the Internal Revenue Code in 1954. Before 1954, the value of the rights of a beneficiary under a survivorship annuity was included in the gross estate of the purchaser of the annuity contract only if the transaction could be fitted into some other provision of the estate tax law. To see the 1954 statute in perspective, it is necessary to sketch in the background.

Suppose *A* purchases a commercial annuity contract under which he will receive $5,000 a year for his life and his wife, if she survives him, will receive the same (or a lesser) amount for her life. This is a "self and survivor contract." Disregarding the insurance company's expenses and profit, *A's* purchase of the contract might be compared to a transfer of property in trust, under which *A* is to receive (a) the income for life, plus (b) part of the corpus each year, if necessary to bring his return up to $5,000 per year. Since a transfer in trust with reservation of the income for life is taxable under §2036 (unless the transfer was

made on or before March 3, 1931), *A's* annuity contract would also seem to be includible under §2036. The parallel is not perfect, to be sure, since *A* is entitled to receive $5,000 per year, but no more, under the contract, whereas if instead of buying the contract he had transferred an equal amount in trust with a reservation of the income, his return in any one year might be more than $5,000. But the cost of *A's* annuity is based on the assumption that *A* for his life, and then his wife for hers, will not only get the income produced by the funds paid for the annuity, but also returns of capital. At one time it was argued that the purchaser of such an annuity contract had not "retained" possession or enjoyment of any property or the income therefrom, as required by §2036, because the consideration he paid for the contract was entirely at the disposal of the insurance company. But the courts finally adopted the view that the value of the wife's rights under such a contract, measured at the time of the purchaser's death,* was includible under what is now §2036. *Commissioner* v. *Clise*, 122 F.2d 998 (9th Cir. 1941), cert. den., 315 U.S. 821 (1942). Of course, if the wife should not survive, the insurance company's obligation to make payments would terminate at the husband's death and there would be no value to be included in his gross estate.

Another common annuity contract provides for payments to both the purchaser and his wife while they both live, with payments continuing to the survivor (a "joint and survivor" annuity). Suppose *A* is to get $2,500 and his wife a like amount while they both live, and the survivor then is to receive $5,000 for life. If *A* predeceases his wife, can the value of her rights at the time of his death be taxed to his estate under §2036? It is of course possible that *A's* $2,500 per year during his wife's life was substantially less than the income that would have been produced if the purchase price of the annuity had been transferred in trust. Does this destroy the analogy suggested earlier? Even if it does, recall that in *Marks* v. *Higgins*, *supra*, p. 1114, a transfer under which the grantor reserved a "contingent" life estate was held to be within §2036. Does not *A*, under the joint and survivor annuity, have at least the equivalent of a contingent life estate, *viz.*, his right to receive $5,000 per year should he survive his wife? Such annuities were held to be taxable under what is now §2036. *Mearkle's Estate* v. *Commissioner*, 129 F.2d 386 (3d Cir. 1942).

Section 2039 of the 1954 Code now takes over from §2036 the responsibility for such annuities as these. It accepts the analogy of transfers with reserved life estates. Like §2036, it applies only to transactions after March 3, 1931, and the last clause of §2039(a) is adopted verbatim from §2036(a).† The House version of §2039 required that "an annuity or similar payment" be payable to the decedent; the Senate changed this phrase to "an annuity or other payment" to make it clear that §2039 applied if the decedent could get a lump-sum payment in lieu of an annuity. (S. Rept. p. 470). Note that §2039(a) is applicable if "an an-

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* It has been held that the beneficiary's rights are to be valued at the cost of obtaining a contract for her at the time of the decedent's death, even if this is greater than the part of the cost of the original contract attributable to her rights. *Estate of Welliver* v. *Commissioner*, 8 T.C. 165, 172 (1947).

† In taking over this language from § 2036(a), the draftsman seems to have overlooked the fact that it came into the statute in 1932 rather than in 1931. *Supra* p. 1106. Section 2036(b) recognizes the difference between the Joint Resolution of March 3, 1931, and the amendment of June 6, 1932, but §2039, although it uses March 3, 1931, as a dividing date, does not.

nuity or other payment *was payable* to the decedent, or the decedent *possessed the right to receive such annuity or payment.*" Is there a difference between an annuity that was "payable" to the decedent and one that he "possessed the right to receive"? Is §2039 applicable if the decedent's *wife* was to receive the annuity for her life and he was to receive payments only if he survived her? Suppose *A*, instead of buying a "self and survivor" annuity, buys two contracts: an annuity for himself; and one for his wife under which payments are to be made only if she survives him. Is §2039 applicable?

The Senate Report states (p.472) that the provisions of §2039 "shall not prevent the application of any other provision of law relating to the estate tax." Consider these possibilities:

1. Could an annuity contract purchased on or before March 3, 1931, be reached by §2037? Under the "self and survivor" contract, the wife gets nothing unless she survives *A*. Does this meet the requirement of §2037(a)(1)? If *A* lives long enough his wife will get nothing. Does this mean that he has a "reversionary interest" within the meaning of §2037(a)(2)? If *A* buys a "joint and survivor" contract under which he and his wife will each get $2,500 while they both live, and the survivor will then get $2,500 for life, is §2037(a)(1) satisfied? What if the survivor's annuity is to increase to $5,000 and *A* dies first? In *Pruyn's Estate* v. *Commissioner*, 184 F.2d 971 (2d Cir. 1950), it was held that the purchaser of a "self and survivor" contract does not have a reversionary interest as that term is used in what is now §2037(a). In *Commissioner* v. *Wilder's Estate*, 118 F.2d 281 (5th Cir. 1941), however, the court held that the wife's rights under a "self and survivor" contract are intended to take effect in possession or enjoyment on her husband's death, which may mean that the court thought the purchaser had a reversionary interest.

2. If §2039 is inapplicable, either because the decedent had no right to receive payments himself or because the contract was purchased on or before March 3, 1931, would §2038 be applicable if the decedent reserved a power to alter or amend the beneficiary's rights?

3. If *A* buys either a self and survivor or a joint and survivor annuity contract for himself and his wife, and if he dies within three years, could the purchase be treated as a gift in contemplation of death under §2035?

4. If the decedent purchased an annuity for himself alone, with no provision for payments to a survivor, §2039 is inapplicable, and there is no value at the date of death to be included under any other provision. But if such a contract provides for a refund to the purchaser's estate if he dies before receiving a specified number of payments (*e.g.*, as in the *Egivedt* case, *supra*, p 138), §2033 would reach the refund. If the refund is payable to a named beneficiary rather than to the purchaser's estate, apparently §2039 would be applicable.

5. If the purchaser of an annuity contract had, until his death, the power to surrender the contract for cash, would the amount he could have obtained just before his death by a surrender of the contract be taxable under §2033?

6. *A* buys a contract providing an annuity for his wife, who is younger than he. His only right under the contract is that he or his estate will receive a refund if his wife should die before her receipts under the contract equal the price he paid for it. *A* dies before his wife has received back the cost of the contract. Is any-

thing includible in *A's* estate? Note that if *A's* wife lives out her life expectancy, there will be no refund. Would the answer depend upon the state of Mrs. *A's* health when *A* dies? See *Hofford* v. *Commissioner*, 4 T.C. 542, 556-7 (1945).

The income tax status of annuities was dealt with *supra*, pp.138-43. A portion of the payments under an annuity contract may be excluded from gross income under §72(b) as a return of capital, but the balance constitutes taxable income by virtue of §72(a). In the case of a survivorship annuity, the exclusion determined under §72(b) is available throughout the contract period, *i.e.*, the primary annuitant is entitled to exclude part of each payment until death and the survivor annuitant excludes a similar portion during his or her life. But §2039 requires the value of the survivor's rights under the contract to be included in the purchaser's gross estate, and the estate tax value may exceed the aggregate amount which the survivor would be entitled to treat as a return of capital under §72(b). For this reason, §691(d) permits the survivor, in the case of a joint and survivor annuity, to deduct an appropriate portion of the estate tax as the payments under the contract come in. The complex relation between the income tax and the estate tax is illustrated by an example in Forster and Frost, "Changes in Taxation of Life Insurance, Endowment, and Annuity Contracts," 1955 *So. Calif. Tax Inst.* 557, 584-5. Does §691(d) offer any relief in the case of self-and-survivor annuities?

See also Murphy, "The Survivorship Annuity· Estate Tax Kaleidoscope," 1 *Howard L.J.* 1 (1955), and, for an older but still useful comprehensive study, Meisenholder, "Taxation of Annuity Contracts Under Estate and Inheritance Taxes," 39 *Mich L. Rev.* 856 (1941).

2. *Employee Annuities*

As the foregoing material indicates, the taxable status of typical joint and survivor annuities was moderately clear even before the enactment of §2039 in 1954, and some of the unsettled issues are still in doubt. In point of fact, however, the primary function of the new section was to clear up the status of survivorship annuities purchased by employers for their employees. The Senate Report states (p.123):

> Under present law the value at the decedent's death of a joint and survivor annuity purchased by him is includible in his gross estate. It is not clear under existing law whether an annuity of that type purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contributions is includible in the decedent's gross estate.

BITTKER
ESTATE AND GIFT TAXATION UNDER THE 1954 CODE: THE PRINCIPAL CHANGES

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(Reprinted by Permission)

A second and more difficult problem under the pre-1954 law was created by employee annuities paid or financed by employers. If an employee, in an effort

* Also published in 29 *Tulane L. Rev.* 453 (1955).

to provide financial security for his wife after his death, bargained with his employer for an increased salary, and used the increased wages to purchase a joint and survivor annuity contract, the survivor's rights under the contract were treated like similar rights under any other purchased annuity contract. But if instead of increasing wages, the employer agreed to provide an annuity upon retirement, with payments to be made to the wife upon the employee's death, the pre-1954 law was far less clear. Since such retirement annuities were customarily payable only if the employee had not died, quit, or been discharged for cause before the retirement date set in the employer's plan, there was some doubt as to whether the employee had any "property" to transfer, and it was almost as doubtful under the cases whether he made a "transfer" by designating his wife as the survivor annuitant under the contract or plan. The Internal Revenue Service attacked primarily contracts under which the employee could choose between (a) an annuity for his life alone and (b) an annuity at a reduced rate for his life with payments to continue to his wife after his death. If the employee elected to take the reduced annuity, the Bureau asserted that he had transferred property within the meaning of Section 811(c) of the 1939 Code. The courts in general rejected this position. *Commissioner* v. *Twogood's Estate*, 194 F.2d 627 (2d Cir. 1952); *Higg's Estate* v. *Commissioner*, 184 F.2d 427 (3d Cir. 1950); Note, 64 *Harv. L. Rev.* 674 (1951). The Internal Revenue Service, however, persisted in its view that the rights of the survivor were includible in the employee's gross estate, at least where he made an election of the kind just described. Rev. Rul. 158, 53-2 C.B. 259; Rev. Rul. 260, *ibid.* 262.

Under the 1954 Code, employee annuities have been divided into two classes.

1. Annuities payable under "qualified" plans that meet the requirements of §401(a). In these cases, the survivor's rights are not includible in the employee's gross estate (except to the extent attributable to payments or contributions by the decedent), for reasons that are obscure. Perhaps the survivor's rights have been analogized to rights under a life insurance policy, but there is no requirement that the decedent give up the incidents of ownership in the contract.* Since Section 2039(c) provides for the exclusion "notwithstanding the provisions of this section or of any provision of law," a right in the decedent to change the beneficiary or to surrender the contract for cash will not be fatal as it would be in the case of life insurance. Moreover, there will ordinarily be no gift tax on the creation of the survivor's rights. If the exclusion was granted on the assumption that benefits under qualified plans are ordinarily minor in amount, it should be noted that that exclusion is needed only if the estate exceeds $60,000 in amount or, in the case of a married decedent who takes full advantage of the marital deduction, $120,000. The rights of the survivor under a qualified plan now constitute a unique class of property that escapes the estate tax despite the retention by the decedent of complete control over the rights of the beneficiary.

2. Other employee annuities. Non-qualified annuity contracts are treated like purchased annuities, *i.e.*, the value of the survivor's rights is includible if attributable to payments by the decedent. Section 2039(b) provides that "any contribution by the decedent's employer or former employer to the purchase price

* *Infra*, p. 1166. [Ed.]

of such contract or agreement . . . shall be considered to be contributed by the decedent if made by reason of his employment." The term "by reason of his employment" is broadly defined by the Senate Report (p. 471) to include cases where:

the annuity or other payment is offered by the employer as an inducement to employment, or a continuance thereof, or if the contributions are made by the employer in lieu of additional compensation or other rights, if so understood by employer and employee whether or not expressly stated in the contract of employment or otherwise.

Although this portion of Section 2039(b) is very broad in its coverage, the scope of the phrase "any *contribution* by the decedent's employer . . . to the *purchase price* of the contract or agreement" is quite uncertain. This language does not seem to embrace annuities paid directly by the employer, where there has been no "contribution" to a "purchase price" other than the recognition of a liability as rights accumulated under the contract.[1] If these contracts indeed are untouched by Section 2039, we must resort to other statutory provisions, since the section is not exclusive. It may also be noted that Section 2039 is restricted to payments under "any form of contract or agreement." The status of the "expectancy" cases, which was cloudy under the 1939 Code, is presumably left unchanged. See G.C.M. 27242, *supra*, p. 983.

3. *Private Annuities.*

ESTATE OF BERGAN v. COMMISSIONER

Tax Court of the U. S., 1943
1 T.C. 543

Margaret L. Goggin and the decedent, Sarah A. Bergan, were sisters. The decedent died in 1939. Kate A. Johnson, a third sister, died intestate December 6, 1932, leaving an estate of approximately $500,000, and her only distributees were her two above named sisters. Shortly after Mrs. Johnson's death, Miss Bergan, who was then 74 but in good health, approached Mrs. Goggin, who was five years younger, with the proposition that Mrs. Goggin was to take all of Mrs. Johnson's estate, except $50,000 in bonds which were to be transferred to Miss Bergan, and that there was to be an oral understanding between the two that Miss Bergan would live with Mrs. Goggin for the remainder of Miss Bergan's life and that Mrs. Goggin was to defray all of the living expenses. That proposition was agreed upon by both sisters and was fully executed. The respondent determined that Miss Bergan in 1933 made a transfer of her share of Mrs. Johnson's estate in excess of the $50,000 of bonds, which excess the respondent has

[1] It may be noted that in Section 105(a), where the draftsman wanted to include payments to employees for personal injury or sickness whether received directly from the employer or under policies of insurance purchased by the employer, the statute speaks explicitly: "to the extent such amounts (1) are attributable to contributions by the employer . . . or (2) are paid by the employer." On the other hand, several of the examples given in the Senate Report to illustrate §2039 refer to contracts "entered into by the decedent and his employer," with no indication that payments are to be made by the employer to a third party. S. Rept. p.470, Examples (3) and (4).

determined was subject to both the gift tax and the estate tax. Petitioner by appropriate assignments of error has contested these determinations.

Black, Judge: . . .

Is this transfer * of Miss Bergan's share of Mrs. Johnson's estate in excess of the $50,000 block of bonds includible in Miss Bergan's gross estate under section 811(c) of the Internal Revenue Code?

We have found as a fact that the transfer was not made in contemplation of death. *Cf. United States* v. *Wells*, 283 U.S. 102. Not any of the evidence points in that direction. At the time the transfer was made Miss Bergan was in excellent health for a woman of her age. Her motives for the transfer were that she did not want to be bothered with looking after that much property, but she did want to be supported for the remainder of her life and to retain the $50,000 so she would have enough income of her own to make gifts to her church and to charity. She had never owned much property and from the year 1904 she had never paid her living expenses. In other words, she wanted things to go on just about as they had been going, and in the making for such an arrangement the thought of death was not the impelling cause of the transfer. The transfer was not testamentary in character. All the facts, we think, tend to show that the transfer was associated with life rather than death.

Nor was the transfer intended to take effect in possession or enjoyment at or after Miss Bergan's death. It was intended to take effect and did take effect immediately. Upon the completion of the transfer in 1933, the title vested in Mrs. Goggin, who was then free to use or dispose of the property in any way she desired. The transfer, although made in consideration for support, was unconditional and irrevocable. Miss Bergan could not possibly retrieve the property transferred or any part of it, and Mrs. Goggin could have disposed of all of it immediately if she had so desired.

The respondent strongly contends that in substance Miss Bergan retained for her life the right to the income from the property transferred, and that for this reason the property must be included in Miss Bergan's gross estate under section 811(c), *supra*. In this connection the respondent points out that the living expenses of Miss Bergan, Mrs. Goggin and her two adult sons, all of which were paid by Mrs. Goggin, were between $25,000 and $30,000 a year, and that, if it took $7,500 a year for Mrs. Goggin to support Miss Bergan, the income from the property transferred (1933 agreed value, $133,662.37) would hardly be sufficient. From this the respondent argues that the result of the agreement between the two sisters was in substance the same as if Miss Bergan had transferred the property in trust with instructions to pay her the income therefrom for life and upon her death to deliver the principal to Mrs. Goggin, citing *Tips* v. *Bass*, 21 F.2d 460 (W.D.Tex. 1927), and *Updike* v *Commissioner*, 88 F 2d 807 (8th Cir. 1937), cert. den. 301 U.S. 708.

We think these cases are distinguishable from the instant estate tax proceeding.

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* It was asserted by the estate that Miss Bergan had "renounced" her interest in Mrs. Johnson's estate, and that a renunciation is not a "transfer" of property under the estate or gift tax statutes. See *Brown* v. *Routzahn*, *infra*, p. 1187. In an omitted part of the opinion, however, the court held that Miss Bergan's action constituted a "transfer" for tax purposes. [Ed.]

In both these cases relied upon by the respondent actual trusts were created to secure the annuities, whereas no trust was created in the instant proceeding. Mrs. Goggin was free to use the property transferred to her in any way that she pleased. The title was vested in Mrs. Goggin and not in any trustee. Miss Bergan did not reserve to herself the income from the property transferred. She had entered into a contract with her sister for support and transferred the property in question as consideration for the contract. In the *Tips* case the Government conceded that the real property transferred of the value of $86,000, which was not placed in trust, was not includible in the gross estate. Although the entire property in the *Updike* case was not placed in trust, the entire transfer in that case was made in contemplation of death, a fact which clearly distinguishes that case from the instant proceeding. In other words, the property transferred in the *Updike* case was included in the gross estate because the transfer was made in contemplation of death and not because the decedent there had in effect reserved to himself for life the income from the property transferred. Of course, In the alternative, petitioner contends that if the transfer was for less than an if we should hold in the instant case that the transfer was made in contemplation of death, it would have many similar features to the *Updike* case, but, as already stated, we hold the transfer was not made in contemplation of death, nor was it intended to take effect in possession or enjoyment at or after decedent's death. The *Updike* case is therefore not controlling. . . . On this issue we sustain petitioner.

We shall now consider the question whether any part of Miss Bergan's share of Mrs. Johnson's estate in excess of the $50,000 block of bonds is taxable as a gift made in 1933. . . .

In deciding the estate tax question we held that Miss Bergan made a "transfer" during the year 1933 of her share of Mrs. Johnson's estate in excess of the $50,000 block of bonds in consideration for Mrs Goggin's promise to support Miss Bergan for the remainder of Miss Bergan's life. The parties agree that in 1933 the value of the property thus transferred by Miss Bergan was the amount of $133,662.37. Petitioner contends that the transfer was for an adequate and full consideration in money or money's worth and that there was, therefore, no gift. adequate and full consideration, the minimum value of such consideration . . . would be $38,880.15, and that only the difference between $133,662.37 and $38,880.15 should be deemed a gift under [§2512(b), 1954 Code]. The respondent contends that the transfer was for less than an adequate and full consideration; that petitioner has failed to prove the value of the consideration, namely, Mrs. Goggin's promise to support Miss Bergan for the remainder of Miss Bergan's life; and that, therefore, the entire value of the property transferred ($133,-662.37) should be deemed a gift under [§2512(b), 1954 Code].

The Committee on Ways and Means, in its report accompanying the Revenue Bill of 1932, referred to [§2512(b)] (Cumulative Bulletin 1939–1, Part 2, p. 477) as follows:

> Since the tax is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth, it is provided in this section that where the transfer is made for less than an adequate and full consideration in money or money's worth, the excess in value of the property transferred over such consideration shall be deemed a gift. For example, if A sells property worth $10,000 to B for $1,000, there is a gift of $9,000.

. . . In the instant gift tax proceeding there was a valid consideration for the transfer in question, namely, Mrs. Goggin's promise to support Miss Bergan for the remainder of Miss Bergan's life, but it was less than an adequate and full consideration for the property which was transferred. Is that consideration reducible to a money value? We think it is. Mrs. Goggin was to support Miss Bergan according to the standard then being enjoyed by the four adults which was at a cost of between $25,000 and $30,000 a year, or an average of between $6,250 and $7,500 for each adult. We adopt the lower figure in view of the insufficiency of the evidence to adequately establish a higher figure than that. We think such a consideration may be valued in the same way that an annuity of $6,250 for Miss Bergan's life would be valued. At the time of the transfer in 1933 Miss Bergan was 74 years of age. According to column 2 of table A mentioned in [Regs. 108, Sec. 86.19], the present value of $1 due at the end of each year during the life of a person 74 years of age is $5.18402, or $32,400.13 for an annuity of $6,250 * This is the same method of computation as petitioner used in arriving at the figures of $38,880.15 as being the value of Mrs. Goggin's agreement to support and maintain Miss Bergan during the remainder of her life. The difference in our figure and that arrived at by petitioner is that we use a figure of $6,250 as the cost of annual support and maintenance for Miss Bergan, whereas petitioner used $7,500 as such annual figure. We find, therefore, that Miss Bergan transferred property of the value of $133,662.37 for an equivalent in money of $32,400.13, and, under [§2512(b)], we hold that the excess of the value of the property transferred over the value of the consideration, or $101,262.24, shall be deemed a gift and shall be included in computing the amount of gifts made by Miss Bergan during the calendar year 1933. . . .

Decisions will be entered under Rule 50.

Note

1. If *A* owns one thousand shares of A.T.&T. stock, on which the annual dividend for many years has been $9.00 per share, and transfers these shares in trust, reserving for himself the income for life, the value of the shares at the date of his death will be includible in his gross estate under Section 2036. Does the statute produce a different estate tax result if he transfers the shares to his children and they agree: (a) to hold the securities for his life and to pay him the dividends therefrom; (b) to pay him $9,000 per year for his life whether they hold the securities or not; or (c) to pay him each year, whether they hold the securities or not, an amount equal to the dividends declared by the American Telephone and Telegraph Company on one thousand shares?

Would the estate tax effect of agreement (a) be affected if the children pledged the securities with *A* or with a third person to insure compliance with their agreement? If any of these three cases is treated differently under the statute than a transfer of the securities in trust with reservation of income for life, is there any reason of policy for doing so?

See Rev. Rul. 55-378, 55-1 C.B.—, involving a trust of $100,000 created by the grantor for the benefit of his children, under which he reserved the right to withdraw $2,500 a year or all of his living expenses: "The decedent did not transfer the property to his children absolutely in consideration of their agreement to pay him $2,500 a year

*This table is still in use for gifts made prior to January 1, 1952 (see Regs. 108, Sec. 86.19(g)) but a revised table computed on the basis of interest at 3½ percent instead of 4 percent is prescribed for gifts made thereafter. Regs. 108, Sec. 86.19(f). [Ed.]

or all of his living expenses but instead he transferred the property into a trust account reserving the right to receive $2,500 a year or all of his living expenses out of the transferred property. Accordingly, it is held that the transfer was not a bona fide sale for an adequate consideration in money or money's worth and is includible in decedent's gross estate" under §2036(a). Is the ruling based on a distinction without a difference?

2. Suppose that *A* transfers the securities to his children in exchange for their promise to pay him not the income therefrom but rather an annuity which, if he lives out his life expectancy, will exhaust the value of the property transferred to them. If he engages in such a transaction with a commercial insurance company, it is clear that nothing is includible in his gross estate. Does or should a different result follow if he enters into such a transaction with his children? If the value of the property which he transfers is worth more than the value of the annuity which his children promise to pay him, and if that difference is taxed as a gift at the time the transaction is entered into, is there any reason for including any part of the value of the securities in the decedent's gross estate?

3. See Wren, "Taxation of Commercial and Private Annuities Under the Internal Revenue Code of 1954," 26 *Miss L. J.* 111, 137-142 (1955); De Carion, "Non-Commercial Annuities and the Federal Gift and Estate Taxes," 9 *Tax L. Rev.* 61 (1953).

Section H. Life Insurance: Section 2042

The Revenue Act of 1916 made no mention of life insurance, with the consequence that proceeds of insurance policies on the life of the decedent were included in his gross estate only when the predecessor of §2033 was applicable. This meant that policies payable to the decedent's estate were taxable, but not policies payable to designated beneficiaries. In 1919, however, Congress enacted a provision, the forerunner of §2042, dealing specifically with insurance on the life of the decedent.* Although the principal purpose of the 1919 legislation was to reach policies payable to designated beneficiaries, it also provided that insurance proceeds "receivable by the executor" were includible in the gross estate. This part of the 1919 legislation has been carried forward to the present, and it now appears as §2042(1). It reaches insurance proceeds that are available for payment of the decedent's debts even though not in form payable to the executor. *Estate of Matthews* v. *Commissioner*, 3 T.C. 525 (1944). Conversely, proceeds payable in form to the executor may escape §2042(1) if local law immunizes them from liability for the decedent's debts and the executor holds them for the benefit of others. *Flick's Estate* v. *Commissioner*, 166 F.2d 733 (5th Cir. 1948); *United States* v. *First National Bank & Trust Co. of Minneapolis*, 133 F.2d 886 (8th Cir 1943); Regs. 105, Sec. 81.26.

The more troublesome part of the 1919 legislation dealt with policies payable not to the executor but to other beneficiaries. It provided for the inclusion of amounts "receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life," except that the first $40,000 of such proceeds were exempt.† The innocent phrase "policies taken out by the decedent"

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* Section 2042 is not applicable to insurance policies owned by the decedent on the life of someone else; such policies are assets of the estate governed by §2033. See, *e.g.*, Du Pont v. Commissioner, 18 T.C. 1134 (1952).

† The 1919 legislation also contained a provision entitling the executor (unless the will provides otherwise) to recover from the beneficiaries of insurance policies their fair share

was productive of nothing but trouble. If the 1919 legislation was to be of any consequence, it could not be limited to policies actually applied for by the decedent. Whether the decedent signed the formal application or not, the policy would serve as a device for transmitting wealth from one generation to another if the decedent paid the premiums. Moreover, even if the decedent neither applied for the policy nor paid the premiums, he could effect the transmission of wealth if he held until his death the power to name or change the beneficiary, to assign or pledge the policy, or to surrender it for its cash value. Was a policy "taken out by the decedent" if he paid the premiums or if he possessed the "incidents of ownership"? Were both necessary? During the long period that the statute included the phrase "taken out by the decedent," regulation succeeded regulation as the Treasury Department turned from one construction to another like a whirling dervish. Its dizzy antics, in part at least an effort to propitiate the courts, are described in Eisenstein, "Estate Taxes and the Higher Learning of the Supreme Court," 3 *Tax L. Rev.* 395, 513–536 (1948); Schlesinger, "Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying," 55 *Harv. L. Rev.* 226 (1941), Paul, "Life Insurance and the Federal Estate Tax," 52 *Harv. L. Rev.* 1037 (1939).

Congress finally intervened. The Revenue Act of 1942 wiped out the $40,000 exemption for policies payable to beneficiaries (simultaneously increasing the over-all estate tax exemption from $40,000 to $60,000) and eliminated the troublesome words "taken out by the decedent." It went on to provide that insurance proceeds payable to designated beneficiaries were includible in the decedent's gross estate if he *either* (1) had paid the premiums directly or indirectly, *or* (2) possessed at the time of his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. The term "incidents of ownership" was not defined by the 1942 statute, but the regulations stated:

> Incidents of ownership in the policy include, for example, the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, *etc.* (Regs. 105, Sec. 81.27(c).)

The 1942 law did provide, however, that a reversionary interest was not an "incident of ownership." But if the decedent possessed a reversionary interest (*e.g.*, if the proceeds would be payable to his estate should the beneficiary predecease him), the proceeds might have been reached by the postponed-possession-or-enjoyment clause of old §811(c).

The 1954 Code made two changes in this pattern of taxing proceeds payable to named beneficiaries. It eliminated the premiums paid test; and it provided that a reversionary interest is an incident of ownership if its value exceeded 5 per cent of the value of the policy immediately before the death of the decedent.

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of the estate tax. There have been only minor questions of construction under this provision, which is now §2206. United States Trust Co. v. Sears, 29 F.Supp. 643 (D. Conn 1939), Marks v. Equitable Life Assurance Soc., *infra*, p 1248; Karch, "The Apportionment of Death Taxes," 54 *Harv. L. Rev.* 10, 25–28 (1940). See also *infra*, pp. 1244-1255.

The elimination of the premiums paid test was perhaps the 1954 Code's most important innovation in the estate tax law.* The Senate Report stated (p.124)

No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified.

Opposing the change, a minority of the House Ways and Means Committee said:

Under present law, if a husband transfers ownership of an insurance policy on his life to his wife, but continues to pay the premiums himself, the proceeds are still considered to be a part of the estate he leaves his wife on his death and are, therefore, included in his estate in computing the estate tax.

It is sought to justify the change as merely putting life insurance on a par with other property which may be given away free from estate tax if the gift is not made "in contemplation of death." But life insurance is not like other property. It is inherently testamentary in nature. It is designed, in effect, to serve as a will, regardless of its investment features. Where the insured has paid the premiums on life insurance for the purpose of adding to what he leaves behind at his death for his beneficiaries, the insurance proceeds should certainly be included in his taxable estate.

We predict that if this provision becomes law, it will virtually do away with the estate taxation of life insurance. To avoid the tax, the insured need only assign the policy to his wife or other beneficiary. Since estates of less than $60,000 are nontaxable, only the wealthy will benefit. Nevertheless, we predict that the estate-tax revenue loss will be substantial. Doubtless life insurance will come into great favor among persons of wealth as a means of avoiding estate taxes.

The proposal goes even further than the method of taxing life-insurance proceeds as a part of estates that prevailed prior to 1942, when an exclusion of $40,000 was provided, which Congress eliminated in the Revenue Act of 1942. (H. Rept. No. 1337, 83rd Cong., 2d Sess., pp. B14–15.)

From 1942 to 1954, the incidents of ownership test was not of great importance, since in most cases the head of the family could not avoid paying the premiums on his insurance directly or indirectly, and consequently the proceeds would be includible under the premiums paid test. But under the 1954 Code, the insured can pay the premiums himself and at the same time keep the proceeds out of his estate by ridding himself of the incidents of ownership. The right to change beneficiaries, to surrender the policy for cash, to pledge it for a loan, to assign it, can be given up easily enough, if the insured wishes to do so. One might also assume that a reversionary interest could be easily avoided, by providing that the proceeds are to be paid to the named beneficiary or, if the beneficiary predeceases the insured, to the beneficiary's estate. But some life insurance counsel have been uneasy because §2042(2) defines the term "reversionary interest" to include "a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him."

* The 1942 premiums paid test was held to be unconstitutional on the ground that it resulted in a "direct" tax and on the further ground that it was retroactively applied in Kohl v. United States, 128 F.Supp. 902 (E.D. Wis. 1954), where the decedent had relinquished the incidents of ownership before the 1942 legislation was enacted and paid no premiums thereafter. As to whether the Congress may constitutionally tax a policy in which the decedent had no property rights, see Lowndes, "Tax Avoidance and the Federal Estate Tax," 7 *Law and Contemp. Prob.* 309, 323–5 (1940).

If the beneficiary is the wife or a child of the decedent, it is argued, the policy or the proceeds may return to the decedent or his estate (1) if the beneficiary makes the decedent his legatee, or (2) if the beneficiary dies without executing a will (possibly by inadvertence or because he is incompetent or a minor) and the decedent is the beneficiary's intestate successor. (Reversionary interests are embraced by §2042(2) "whether arising by the express terms of the policy or other instrument or by operation of law.") In stating that the term "reversionary interest" includes "a possibility" that the proceeds may return to the decedent's estate, §2042(2) merely carries over the definition of "reversionary interest" found in §2037(b). Does §2037(b) apply if the decedent may get the property back because the donee gives it back or because he is the donee's intestate successor? *Supra*, p. 1144. Can the suggestion that the decedent has a reversionary interest in life insurance because the proceeds may come to his estate by bequest or inheritance be reconciled with the manifest purpose of Congress in eliminating the premiums paid test? See Mannheimer, Wheeler and Friedman, "Gifts of Life Insurance by the Insured," *13th N.Y.U Inst. on Fed. Tax.* (1955) 247, 251; reprinted in 33 *Taxes* 299, 301 (1955). If the term "reversionary interest" includes the kind of expectancy just described, how is the 5 per cent rule to be applied? The Senate Report states (p. 473):

In determining whether [a reversionary interest] exceeded 5 percent, this section [§2042] provides rules substantially the same as prescribed in section 2037 for determining whether, in the case of certain transfers, the decedent retained a reversionary interest in the transferred property.

In applying the 5 per cent rule, how is "the value of the policy immediately before the death of the decedent" to be determined? Is it the cash surrender value? See *Guggenheim* v. *Rasquin*, next paragraph. If the decedent "immediately" before his death was suffering from a protracted illness, or if he was in an automobile that had just gone over a cliff, is the "value" of the policy its full face amount?

The repeal of the premiums paid test will no doubt bring in its train many transfers of policies that have been in force for some time. The transfer of such a policy is a "gift" under §2511(a), and a gift tax may be due. How is the policy to be valued? In *Guggenheim* v. *Rasquin*, 312 U.S. 254 (1941), a donor made a gift of three single-premium life insurance policies (with an aggregate face amount of $1,000,000) immediately after purchasing them. Although she had paid about $852,000 in premiums, the cash surrender value of the policies was only about $717,000, and she valued them at the lower amount on her gift tax return. The Supreme Court held that the proper value was her cost:

Cash-surrender value is the reserve less a surrender charge. And in case of a single-premium policy the reserve is the face amount of the contract discounted at a specified rate of interest on the basis of the insured's expected life. If the policy is surrendered, the company will pay the cash-surrender value. It is asserted that the market for insurance contracts is usually the issuing companies or the banks who will lend money on them; that banks will not loan more than the cash-surrender value; and that if policies had an actual realizable value in excess of their cash-surrender value, there would arise a business of purchasing such policies from those who otherwise would surrender them. From these facts it is urged that cash-surrender value represents the amount which would be actually obtained for the policies in a willing buyer-willing seller market. . . .

That analysis, however, overlooks the nature of the property interest which is being valued. Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. See *Chase National Bank* v. *United States,* 278 U.S. 327, 335; Vance on *Insurance* (2d ed.) pp.54–56. But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value—in the instant case over $135,000. All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. To single out one and to disregard the others is in effect to substitute a different property interest for the one which was the subject of the gift. In this situation as in others (*Susquehanna Power Co.* v. *State Tax Comm'n,* 283 U.S. 291, 296) an important element in the value of the property is the use to which it may be put. Certainly the petitioner here did not expend $852,438 50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them Cost is cogent evidence of value. And here it is the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single-premium policy—the right to retain it as well as the right to surrender it. Cost in this situation is not market price in the normal sense of the term. But the absence of market price is no barrier to valuation.

Although the Supreme Court held that the cost of the policy was the proper measure of its value in this case, the cash surrender value of a policy that has been in force for same time might exceed the aggregate premiums paid. Moreover, neither the cash surrender value nor the aggregate cost is a fair index of the value of the policy if the insured has become uninsurable. In *United States* v. *Ryerson,* 312 U.S. 260 (1941), the Court said of a gift of such policies:

The cost of duplicating the policies at the dates of the gifts is, in absence of more cogent evidence, the one criterion which reflects both their insurance and investment value to the owner at that time. . . . The fact that the then condition of an insured's health might make him uninsurable emphasizes the conclusion that the use of that criterion will result in placing a minimum value upon such a gift.

See Regs. 108, Sec. 86.19(i); *cf. Goodman* v. *Commissioner,* 156 F.2d 218 (2d Cir. 1946).

If the insured, after transferring the policy, continues to pay the premiums to keep it in force, these annual payments will be transfers subject to gift tax. See Regs. 108, Sec. 86.2(a)(8).

Is the transfer of a policy or the subsequent payment of premiums a gift of a present or of a future interest? Does this depend on whether the policy has a cash surrender value? On whether the donee could surrender it for cash without undue sacrifice of its other values? See 2 Paul, *Federal Estate and Gift Taxation* §15.11 (1942 and 1946 Supp.); 4-A P-H Fed. Tax Serv. ¶126,281 (1955); Rev. Rul. 55–408, 55–1 C.B. —.

The possibility that the transfer of an insurance policy will be taxed as a gift in contemplation of death, if the donor-insured dies within three years, must not be overlooked. If the insured makes the transfer to rid himself of the incidents of ownership so as to avoid estate tax, is the transfer *ipso facto* a gift in contemplation of death? Does the fact that a policy will take on added value at the donor's death mean that insurance is "inherently testamentary" so that a transfer

is more likely to be a gift in contemplation of death than a transfer of other property? See *Garrett's Estate* v. *Commissioner*, 180 F.2d 955 (2d Cir. 1950), involving a life insurance trust:

We have twice recently considered under what circumstances the transfer of policies upon a settlor's life should be taken as made in contemplation of death [*First Trust & Deposit Co.* v. *Shaughnessy*, 2 Cir., 134 F.2d 940; *Vanderlip* v. *Commissioner*, 2 Cir., 155 F.2d 152]; and we have said that it did not inevitably follow, even though the beneficiaries cannot receive any part of the proceeds, living the settlor, that the gift was so made. The settlor may have wished to part with control over the policies for motives which were to be satisfied while he lived; for example, he may have wished to assure himself against any temptation to use them in his business; or he may have feared possible bankruptcy, or have wished to give the beneficiaries a present certainty on which they might build while he lived. Nevertheless, although for these reasons it would go too far to say that a transfer of policies can never be other than testamentary, when the beneficiary cannot possibly profit by them, living the settlor, ordinarily such a transfer will be of that kind. A conveyance of property which the grantee can by no chance use until the grantor's death, will so commonly be in the main testamentary, that it is fair to infer that that was its preponderating, if not indeed its only, purpose, unless there be affirmative evidence of other contributory motives.

Note the similarity of this reasoning to the same court's decision in the *Reeves' Estate* case, *supra*, p. 1058. A different approach to life insurance is found in *Flick's Estate* v. *Commissioner*, 166 F.2d 733 (5th Cir. 1948):

Even though it be true, as the Tax Court reasoned, that all life insurance reaches its greatest value at the death of the insured, nevertheless Congress has not undertaken to convert a valid, absolute, complete gift inter vivos into a gift causa mortis or a substitute for testamentary disposition merely because the gift will have a greater value after the death of the donor. (166 F.2d at 740)

The *Garrett's Estate* case involved insurance policies transferred in trust. Would the Court of Appeals for the Second Circuit apply the same reasoning to policies with cash surrender or loan values that are assigned directly to the beneficiaries, so that they can either cash or borrow against the policies immediately? See Hodge, "Life Insurance and the Estate Tax," 25 *Taxes* 352 (1947); Guterman, "Transfers of Life Insurance and the Federal Estate Tax," 48 *Col. L. Rev.* 37 (1948); Fraenkel, "Taxation of Insurance Policies as Transfers in Contemplation of Death," 3 *Tax L. Rev.* 160 (1947).

If the insured pays the premiums on a policy that he has transferred or on a policy that he never owned, could the payment be a gift in contemplation of death? If so, would the taxable amount be the full face value of the policy, the sum of the premiums paid in the three years before his death, or some other amount?

The fact that upon the transfer of an existing policy the donee gets the right to obtain its cash surrender value (if any), plus the fact that such an *inter vivos* transfer is subject to gift tax, led the draftsmen of the American Law Institute's model estate and gift tax law to propose an estate tax provision for insurance that takes a middle route between the 1942-54 law and the 1954 Code:

Where the decedent makes an inter vivos transfer of a life insurance policy the gift tax will apply to the transfer. Moreover, the transfer does permit the donee to obtain the present enjoyment of some part of the policy, since he can presently obtain the cash surrender value. The [1942–54] premium payment test included under the estate

tax the entire proceeds of the policy and gave a credit for any gift tax paid. It did not take account of the ability of the donee to obtain the cash surrender value during the decedent's lifetime. The [A.L.I.] Draft, however, proceeds on the premise that recognition should be given to this factor. Thus, suppose a decedent purchased and transferred a paid-up policy which cost $40,000, had a cash surrender value of $60,000 at his death, and had a face amount of $75,000. The gift tax would be imposed on $40,000. If recognition is to be given to the present interest of the decedent, then the estate tax should include only $75,000 less $40,000. Under this view, the entire policy would be subject to the transfer taxes, $40,000 to the gift tax and $35,000 to the estate tax. There would be no gift tax credit. If the policy was not fully paid up and the decedent after the transfer continued to pay the annual premiums, then the amount to be subtracted from the face amount would be the sum of the initial amount subject to the gift plus each annual premium, which in turn was subject to the gift tax. In fact, probably only the portion of each annual premium which was reflected in the increase in the terminal reserve value should be counted, since the balance went to the current year's insurance protection. This last limitation would be consistent with the gift tax value counted for the initial transfer. However, those that stress the view that recognition should be given to the ability of the donee to obtain the cash surrender value during the decedent's life also stress that under this approach it is more appropriate to subtract the cash surrender value just prior to the decedent's death. If the donee had acted to obtain this amount, that would have ended the matter and any difference between that value and the amounts previously subject to gift tax would go untaxed.

The fact that the donee does not terminate the policy should not alter the result. Hence, in the above example, it is urged that the estate tax apply to the face amount, $75,000, less the cash surrender value of $60,000 or $15,000. This would leave $40,000 subject to the gift tax and $20,000 not subject to either tax. There would be no gift tax credit.

The Draft in section X2013(b)(2)(A) takes the latter view. Basically it subjects to the estate tax the difference between the face amount and the cash surrender value immediately prior to the decedent's death. (American Law Institute, Federal Income, Estate and Gift Tax Statute, Tentative Draft No. 10, 1955, p.227.)

The 1954 repeal of the premiums paid test may presage a revival of the life insurance trust, a device by which property is transferred in trust the income from which is to be used to pay premiums on insurance on the settlor's life. (The settlor either transfers his insurance policies at the same time or the trustee takes out new policies.) Upon the settlor's death, the beneficiaries receive both the insurance proceeds and the property whose income was previously used to keep up the policies. Before 1954, the insurance proceeds would be includible in the settlor's gross estate because he had paid the premiums indirectly, and the trust corpus would also have been includible, at least during the period when *Reinecke v. Northern Trust Co.* was no longer followed (1948-54, *supra*, pp. 1138–9), because the beneficiaries' possession or enjoyment matured at the time of his death. Under the 1954 Code, §2042 would not reach the insurance proceeds and §2037 would not reach the corpus if the settlor had no incidents of ownership in the policy and no reversionary interest in the corpus. Would §2036 be applicable to the corpus? Note that the income of the trust would continue to be taxed to the settlor under §677(a)(3), *supra*, p.315; the 1954 repeal of the premiums paid test for the estate tax was not accompanied by a revision of the theory that the payment of premiums on life insurance is so important an expenditure for the average taxpayer that the income of a trust that relieves him of that expense should be taxed to him even if the policies have been irrevocably assigned.

BOHNEN v. HARRISON

U.S. Court of Appeals, Seventh Circuit, 1952
199 F.2d 492

Before DUFFY, LINDLEY and SWAIM, Circuit Judges.

LINDLEY, Circuit Judge.

The Collector of Internal Revenue, defendant in the suit below, appeals from a judgment of the District Court granting the taxpayers' motion for judgment on the pleadings in an action to recover overpayment of estate taxes. The controlling facts, a clear analysis of the issues and an adequate exposition of the pertinent law appear in Judge Campbell's decision in *In re Bohnen*, D.C., 100 F.Supp. 118. However, because there are two decisions to the contrary, one of which was announced after the judgment below was entered, it may well be advisable, we think, to add our additional thought upon the questions presented.

The decedent bought two insurance contracts. One, an annuity policy, recited that, in consideration of the payment of a premium of $22,602.96, the insurance company would pay Mrs. Bohnen, until the date of her death, a fixed annuity of $1,618.03 annually. In the other, a life insurance policy, the company agreed, in consideration of the payment of a single premium of $53,717.04, to pay, upon receipt of due proof of the death of the insured, the sum of $72,000. Neither contract contains any reference to the other. The promise to pay the annuities was made in consideration of one thing only, the payment of $22,602.96, and the agreement to pay the life insurance, upon the sole consideration of the payment of the single premium of $53,717.04.

[On the day she purchased the contracts, the decedent assigned her entire right, title and interest to the insurance policy to her children, and she reported the assignment on a federal gift tax return. On her death, the Commissioner included the insurance proceeds in her gross estate on the ground that she had made a transfer under which she retained for her life the right to the income from the transferred property.]

Though the Supreme Court has decided * that such an arrangement is in the

* In Helvering v. Le Gierse, 312 U S 531 (1941), the Court had to decide whether the proceeds of an insurance policy that had been taken out by an elderly woman in conjunction with an annuity contract qualified for the special $40,000 exemption granted to life insurance before 1942. The facts, as set out by the Court, were as follows

"Less than a month before her death in 1936, decedent, at the age of 80 executed two contracts with the Connecticut General Life Insurance Co. One was an annuity contract in standard form entitling decedent to annual payments of $589.80 as long as she lived. The consideration stated for this contract was $4,179. The other contract was called a 'Single Premium Life Policy—Non Participating' and provided for a payment of $25,000 to decedent's daughter, respondent Le Gierse, at decedent's death. The premium specified was $22,946. Decedent paid the total consideration, $27,125, at the time the contracts were executed. She was not required to pass a physical examination or to answer the questions a woman applicant normally must answer.

"The 'insurance' policy would not have been issued without the annuity contract, but in all formal respects the two were treated as distinct transactions. Neither contract referred to the other. Independent applications were filed for each. Neither premium was computed with reference to the other. Premium payments were reported separately and entered in

nature of a single investment program and, therefore, not within the definition of insurance mentioned in the former act, $40,000 of which was then allowed to be deducted from the gross estate of a decedent, it does not follow that this investment program, made up of the two contracts, was indivisible. On the one hand, it is obvious that for the consideration of some $22,000 a fixed annuity of $1,600 was bought and that, on the other, in consideration of the sum of some $53,000 advanced, the company agreed to pay, at the insured's death a fixed sum of $72,000. The annuities were not based upon and in no wise dependent upon any consideration given for the life policy. The money to be paid under the life contract was in no wise based or dependent upon the sum advanced to secure the annuities. The two contracts constituted independent units, two pieces of property. Consequently, when the insured immediately transferred and assigned all of her right, title and interest of every character in and to the policy of insurance, that unit of her estate passed to the assignees, and was no longer her property. It could, therefore, under no conception, constitute a part of her taxable estate when she died thereafter.

But, says the Collector, it is undisputed that the life policy would not have issued if the decedent had not also bought the annuity policy. This fact, we think, is without legal significance, for, as we have said, the decedent purchased two pieces of property, paying for one, which she retained, $22,000. For the other, the contract to pay $72,000 upon her death, she paid $53,000. The second agreement she immediately transferred by way of gift to her three children, making a gift tax return and paying the tax due thereon. She retained no interest in the life contract; thereafter, she no longer had any dominion over it. She did nothing to bring herself within the transfers made taxable by the Internal Revenue

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different accounts on the company's books. Separate reserves were maintained for insurance and annuities. Each contract was in standard form. The 'insurance' policy contained the usual provisions for surrender, assignment, optional modes of settlement, *etc.*"

The $40,000 exemption was denied:

"The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides, and was found as a fact by the Board of Tax Appeals that the 'insurance' policy would not have been issued without the annuity contract. Failure, even studious failure, in one contract to refer to the other cannot be controlling. . . .

"Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the 'insurance' contract looks like an insurance policy, contains all the usual provisions of one, and could have been assigned or surrendered without the annuity. Certainly the mere presence of the customary provisions does not create risk, and the fact that the policy could have been assigned is immaterial since no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued, still counteracted each other. It may well be true that if enough people of decedent's age wanted such a policy it would be issued without the annuity, or that if the instant policy had been surrendered a risk would have arisen. In either event the essential relation between the two parties would be different from what it is here. The fact remains that annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other From the company's viewpoint, insurance looks to longevity, annuity to transiency . . .

"Here the total consideration was prepaid and exceeded the face value of the 'insurance' policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above. It follows that the sums payable to a specific beneficiary here are not within the scope of §302(g) [Revenue Act of 1926, as amended]." [Ed.]

Code, either by making a transfer in contemplation of death or by retention of any interest or possibility of reverter.

The District Court discussed the case of *Burr* v. *Commissioner*, 2 Cir., 156 F.2d 871 and we need add little to its exposition. In that case the court considered a state of facts similar to that confronting us here to be within the doctrine of *Helvering* v. *Le Gierse*, 312 U.S. 531. But the latter opinion decided only that the contracts, read together, constituted not insurance but an investment program. There, the life insurance policy had not been assigned. In the *Burr* case, the policy had been transferred, but the court seemed to think that that made no difference. In our opinion, in the *Burr* case, the court went far beyond the narrow holding of the *Le Gierse* case, where ownership of the life policy was retained by the decedent until the time of her death. In the *Le Gierse* case the court could not well have taken any position other than the one it did take, it seems to us, for the policy-holder retained the insurance policy and all interest in and control over it until his death. Only then did it become due and payable, as a part of his estate.

In the *Burr* case the court said that the insured in "assigning the policies, he was in effect, transferring a remainder while retaining a life interest or . . . retaining the enjoyment or the right to the income from the property." [156 F.2d 872.] This is certainly not true of the present case, for here the insured retained no interest whatever in the insurance policy or in the income therefrom.

In *Conway* v. *Glenn*, 6 Cir., 193 F.2d 965, decided subsequently to the entry of the judgment here, the court followed the reasoning of *Burr* v. *Commissioner*, *supra*, attributing to the *Le Gierse* decision controlling effect even where the policy is assigned. As we read the *Le Gierse* opinion, the Supreme Court said nothing in it to impel the conclusion that, after complete assignment of the life insurance policy, the decedent retained any interest therein. . . .

It is contended that the annuity payments constituted income from the life policy. It would seem that to state the proposition is to demonstrate its fallacy. The annuities were bought and paid for in the annuity contract, when the insured paid in $22,000. None of this came out of the life insurance premium. The life policy was fully paid for by the $53,000 advanced for it; no part of it contributed in any way to the annuities. If the assignees had cashed the life policy, as they had a right to do, the insured would have still been entitled to receive the annuities. The assignees were in truth, not by any fiction, the absolute owners of the life policy, whereas the decedent kept for herself the annuity contract.

The judgment is affirmed.

DUFFY, Circuit Judge (dissenting).

In 1935, when decedent was 62 years of age, she purchased a life insurance policy in the face amount of $72,000, paying a single premium of $53,717.04. A physical examination of decedent was not required. On the same date and as a part of the same transaction she purchased an annuity contract for a single premium of $22,602.96, which provided for annual payments to her until her death of $1,618.03. The insurance company required that the annuity contract be purchased as a condition of issuing the life insurance policy to her.

The majority opinion points out that the contracts were separate, and that

neither contained a reference to the other, and states that they constituted two independent pieces of property. While admitting that the United States Supreme Court in *Helvering* v. *Le Gierse*, 312 U.S. 531, held that a similar transaction to that in the case at bar was a single investment program, the majority states, ". . . it does not follow that this investment program, made up of the two contracts, was indivisible." It further states that the fact that the life insurance policy would not have been issued if decedent had not bought the annuity policy is without legal significance.

In reaching its conclusion, I think the majority gives only lip service to the decision of the Supreme Court in *Le Gierse*. In that case the life insurance policy, in standard form, containing the usual provisions including those for assignment or surrender, was issued to a woman 80 years of age, without physical examination, for a single premium less than the face of the policy. The company also issued an annuity policy for another premium, calling for annual payments to her until her death. The Supreme Court held that although both policies were on the face separate contracts, neither referring to the other, they must be considered together; that in case of a premature death, the gain to the insurance company on one policy would neutralize its loss under the other; and that there was in fact no insurance risk. The issue in that case, as stated by the court, 312 U.S. at page 537, was: "The ultimate question is whether the 'insurance' proceeds may be included in decedent's gross estate," the statute at that time providing that insurance in excess of $40,000 was to be considered as a part of such estate. And the court ruled, 312 U.S. at page 540:

> The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the "insurance" policy would not have been issued without the annuity contract. Failure, even studious failure, in one contract to refer to the other cannot be controlling.

In my opinion the majority refuses to accept the rationale on which the Supreme Court decided *Helvering* v. *Le Gierse*, *supra*, and the companion cases of *Estate of Keller* v. *Commissioner*, 312 U. S. 543, and *Tyler* v. *Helvering*, 312 U.S. 657. While, as pointed out, the ultimate issue in the *Le Gierse* case was different than in the case at bar, the cases are alike in that in each a life insurance policy and an annuity contract were issued to the decedent as separate contracts, and in each the life insurance policy was issued without any medical examination and would not have been issued except in conjunction with the purchase of the annuity contract. In the case at bar the effect of the combination of contracts is that decedent invested a sum of money with respect to which she reserved the right to the income for her life, and transferred to her children, as the owners of the insurance policy, the right to receive the insurance upon her death. In my opinion such a transfer is squarely within the provisions of Sec. 811(c)(1)(B), [1939] Internal Revenue Code [§ 2036, 1954 Code], and the insurance proceeds should be included in the taxable gross estate.

Except for the decision by the learned district judge who sat in this case, all cases on this point have been decided contrary to the holding of the majority herein. I think that the decision of the Second Circuit in *Burr* v. *Commissioner*, 156 F.2d 871, certiorari denied 329 U.S. 785, and the decision of the Board of

Tax Appeals in *Estate of Cora C. Reynolds* v. *Commissioner of Internal Revenue*, 45 B.T.A. 44, were correctly decided. In addition, the attention of the Sixth Circuit was particularly directed to the decision of the trial court in this case, and such view was rejected by that court in *Conway* v. *Glenn*, 193 F.2d 965.

Feeling that the decision of the district court should be reversed, I must respectfully dissent.

Note

1. The *Bohnen* case was affirmed without opinion by an equally divided Supreme Court, 345 U.S. 946 (1953). The Internal Revenue Service has announced that it will follow the *Burr* case rather than the *Bohnen* case. Rev. Rul. 54–552, 54–2 C.B. 284; see "Combined Annuity and Single Premium Life Insurance Under the Estate Tax: Effect of Assigning the Insurance," 62 *Yale L. J.* 822 (1953); Meisenholder, "Taxation of Annuity Contracts Under Estate and Inheritance Taxes," 39 *Mich. L. Rev.* 856, 883–887 (1941); West, "Taxation and Life Insurance For Elderly Persons," 20 *Taxes* 204 (1942).

Does the elimination of the premiums paid test by the 1954 Code mean that if the incidents of ownership of such an insurance policy are relinquished, the proceeds must not be included in the gross estate? Is §2039 applicable?

In the *Burr* case, the court stated:

> Had the sons actually cashed the insurance policies, the contracts would have been separated and the insurance company would then have had to make annuity payments out of income and capital from the annuity premium. (156 F.2d at 872.)

In that event, apparently the court would not have included the proceeds of the insurance policy in the insured's gross estate. But if the decedent transferred property with a reservation of the income so as to be taxable under what is now §2036, as the court held, why does the sale or surrender by the remainderman of his interest remove the property from the life tenant's gross estate? See *Estate of Hutchinson* v. *Commissioner*, 20 T.C. 749, 756 (1953).

2. In *Commissioner* v. *Treganowan*, 183 F.2d 288 (2d Cir. 1950), cert. denied 340 U.S. 853, the court had to say whether the estate tax provision relating to insurance reached a "death benefit" of $20,000 paid to the decedent's widow on his death by the "Trustees of the Gratuity Fund" of the New York Stock Exchange, of which the decedent had been a member:

> Since 1873 the Exchange has had a plan providing for the payment by the surviving members of a certain sum to the families of deceased members. The constitution of the Exchange sets up for this purpose a Gratuity Fund and provides that before any one may be elected to membership in the Exchange he must make a contribution to the Gratuity Fund of $15. By the constitution the member also "pledges himself to make, upon the death of a member of the Exchange, a voluntary gift to the family of each deceased member in the sum of fifteen dollars." The constitution also pledges the faith of the Exchange to pay, out of these assessments, $20,000, or so much thereof as may have been collected, to the persons named in the next section of the document. The persons there named were the widow and children of the member or issue of a deceased child or children, or if he died leaving neither widow, child, nor issue of a child, then to his legal heirs or the persons who would, under the laws of New York, take the same by reason of relationship to him had he owned the same at the time of his death. No member has at any time had the right to name, select, or designate any beneficiary or beneficiaries other than those named above, nor may the proceeds be assigned or pledged for the payment of any debt.

> Although the constitution provides that the beneficiaries of a deceased member are to receive the full $20,000 only if that amount is collected, practically it is certain that the full amount will be paid. Under Art. X, §5, of the constitution of the constitution of the Exchange, members are subject to loss of their seats for failure to meet any assessment, including the contribution due on decease of a member.

Was the "death benefit" insurance? If so, did the decedent have any of the incidents of ownership within the meaning of §2042?

Chapter 13

THE GROSS ESTATE: POWERS OF APPOINTMENT

RESTATEMENT OF THE LAW OF PROPERTY

St. Paul· The American Law Institute, 1940, Vol. 3, pp. 1808–09, 1811–15.
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Owners often wish to control the devolution of their property through two or more generations; and the rule against perpetuities does not prevent an owner who is competently advised from exercising such control for about a century. Plainly no human foresight is adequate to frame in advance dispositions which will meet the exigencies of the maximum period of control or even of the comparatively small fraction thereof commonly utilized by testators and settlors. Births and deaths in varying combinations, the commercial success of some family members and the failure of others, the varying capacities of individuals as to the husbanding of resources, fluctuation in income returns and the value of the monetary unit, legislative action and constitutional amendment reflecting social and political change—all these are factors whose unpredictability indicates the folly of rigid predetermined future limitations and the desirability of gifts containing a substantial element of flexibility. The power of appointment, particularly the special power, is the most efficient device yet contrived by which an owner may obtain such flexibility while still controlling the general purposes to which his property shall be devoted. When A leaves his property in trust for his son, B, for life and then in trust for such children of B as B shall by will appoint, he makes it possible for the manner of distribution among B's children to be determined in accordance with the changes which may occur during the rest of B's life while at the same time ensuring that the remainder interest will not be diverted from the children. In a sense the power of appointment extends the personality of A through the balance of the life of B. . . .

A power of appointment was originally conceived to be merely an authority in the donee to do an act for the donor. Thus, where A effectively devised Blackacre to B for life, remainder to such person (or such children of B) as B should appoint, B's power was considered in substance as an authority to fill in a blank in A's will. When B exercised the power by making an appointment to C, C was considered to receive the property by transfer from A, not from B; and the appointment was said to "relate back" to the time of creation of the power and to operate as if it had been originally contained in A's will. Many of the characteristic rules of the law of powers are accounted for by the conception of a power as a mere authority and its doctrinal corollary of "relation back." . . .

However, the "relation back" theory has never been consistently followed. Departures have been and are particularly marked with regard to general powers presently exercisable, for it is clear that where the power of B, the donee, to dispose of A's property includes a power to appoint to himself he has a substantial interest in the property, proprietary in its nature. The power to become the owner at will is in essence ownership, or, to put it differently, when B appoints to C, the transaction is essentially the same as if B, as donee of the power, had appointed to himself and then, as owner, had conveyed to C. . . .

The current American law of powers is the outgrowth of a fundamental acceptance of the "relation back" doctrine, with fairly frequent and important departures in situations where the proprietary aspect of the power is most apparent. . . .

The general power presently exercisable is the practical equivalent of ownership, since it gives to the donee the power to acquire ownership at any time by appointing to himself. . . .

The general testamentary power is the equivalent of ownership with this considerable limitation: the donor has provided that no appointment shall be effective until the donee's death and therefore the donee cannot appoint to himself, though he can appoint to his estate or to any other person whomsoever after his death. . . .

The special power presently exercisable, as well as the special testamentary power, differs fundamentally from all general powers. It is in no proper sense ownership. It is a power to dispose of the donor's property among a group, not including the donee—a power which is to a considerable extent fiduciary in its nature. Thus it follows that the donee cannot derive any profit direct or indirect from the appointment (§§351–355); that his ability to transfer to others the exercise of his discretion is considerably limited (§359); that his creditors cannot reach the property and thereby benefit a person to whom he could not appoint.

McDOUGAL
FUTURE INTERESTS RESTATED: TRADITION VERSUS CLARIFICATION AND REFORM

55 Harv. L. Rev. 1077, 1112–14 (1942)
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Flexibility of disposition the general power of appointment by deed or will does, beyond doubt, give. The fact is, ancient dogma notwithstanding, that under such a power the donor has prescribed no "limits" for the donee's discretion; he has given the donee a "blank check"; not even the "fee" or the "whole property" could give a wider range of choice among possible beneficiaries. Even if the power is "special," even if the donor does limit the donee's beneficence to a group "not unreasonably large," the donee may still have all of the control which most people want and still be able to send the property where most people want to send it; he may be restrained only from giving to charity or out of his blood line. Where, furthermore, the power, general or special, is "testamentary" only—even though the dead hand may withhold the power of disposal by deed from the

living—the donee may still have for all practical purposes, such control over claims, goods, and resources that he should, from a policy perspective and for most purposes, be treated as "owners" are treated. Of what benefit is it to creditors, spouses, and the public (here represented by the tax collector) that the dead should limit the discretion of the living in the choice of ultimate beneficiaries or confine the exercise of such discretion to wills rather than deeds? Why should flexibility of familial disposition, desirable end though it may be, be purchased at the expense of all of these people? . . . For what good reason should contemporary American taxpayers be allowed to skip a generation or two of estate and inheritance taxes by the use of a verbal form invented several centuries ago to enable an English gentleman to make a will of land?

Note

See also Griswold, "Powers of Appointment and the Federal Estate Tax," 52 *Harv. L. Rev.* 929 (1939), response by Leach, *ibid.*, 961; reply by Griswold, *ibid.*, 967, Schuyler, "Powers of Appointment and Especially Special Powers—The Estate Taxpayer's Last Stand," 33 *Ill. L. Rev.* 771 (1939); Eisenstein, "Powers of Appointment and Estate Taxes: I," 52 *Yale L. J.* 296 (1943). Casner, "Estate Planning—Powers of Appointment," 64 *Harv. L. Rev.* 185 (1950).

Chapters 11 and 12 of this book were concerned primarily with property that the decedent either owned when he died or transferred during his life by testamentary disposition. This chapter concerns itself with the taxability of property which the decedent never owned but over which he had a power of appointment. In *Helvering* v. *Safe Deposit & Trust Co., supra*, p. 973, it was pointed out that the Revenue Act of 1916 said nothing about property over which the decedent had a power of appointment, and that *United States* v. *Field*, 255 U.S. 257 (1921), held that such property was not the property of the decedent within the meaning of the predecessor of §2033. The court also held that such property was not reached by the postponed-possession-or-enjoyment clause because that clause embraced only transfers of the decedent's own property. In 1919, however, the statute was amended, and from then until 1942 the estate tax reached "any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death. . . ." * Because the property was not subject to the estate tax unless the power was *exercised*, the holder of the power (the "donee") could enjoy the control of an absolute owner with impunity. *Helvering* v. *Safe Deposit & Trust Co., supra*, p. 973. For example, the head of a family could transfer his entire fortune in trust, giving his son the income for life and a general power of appointment over the corpus and designating his grandchildren as takers in default. The son's estate would not be taxed on the corpus, despite his

* Bona fide sales were excepted. The Revenue Act of 1932 added, after the quoted language, the following "or (3) by deed under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; . . ." *Cf. supra*, pp. 1106–7.

dominion and control over it, if he was content to have it go to the takers in default. Moreover, if the son's power was not a "general" power of appointment, he could exercise it without incurring estate tax liability. Thus, if in the example just given the son's power was a power to appoint only to his wife or children, the property would not be included in his estate even if he exercised the power. In *Clauson* v. *Vaughan*, 147 F.2d 84 (1st Cir. 1945), a son was given a power to appoint to anyone except his wife (from whom he was later divorced) and her family. Admitting that "a trivial or fake limitation obviously imposed for the purpose of tax evasion" might be ignored, the court held that the power in question was not "general" even though the son could appoint to anyone in the world, including himself, so long as none of the property went directly or indirectly to his first wife or her family.

In 1942, the powers of appointment provision was completely revised. The 1942 legislation made economic power or dominion, rather than actual exercise of the power, the critical criterion for taxing property subject to a power of appointment the property was includible if the decedent possessed a power of appointment (as defined by the new statute) at the time of his death, whether he exercised it or not. In reaching unexercised powers, the 1942 legislation was analogous to §2038, which reaches property transferred by the decedent if he retains a power over it until his death The 1942 provision also taxed property if the decedent during his life exercised or released a power of appointment in contemplation of death or by other testamentary disposition. In addition to abandoning the 1919–42 dichotomy between exercised and unexercised powers, Congress in 1942 adopted a statutory definition of the term "power of appointment," instead of leaving to the courts the determination of what powers were sufficiently "general" to be subject to tax Under the 1942 law, the term "power of appointment" meant any power to appoint exercisable by the decedent alone or in conjunction with another person unless (a) the decedent could appoint only to certain members of his family or of the donor's family or to charities, or (b) the decedent had a quasi-fiduciary power to appoint only within "a restricted class" and could not exercise the power in his own behalf. Special provision was made for powers created on or before October 21, 1942, when the new legislation was adopted. See generally Eisenstein, "Powers of Appointment and Estate Taxes: II," *52 Yale L.J.* 494 (1943); Alexander, "Taxation of Powers of Appointment under the Revenue Act of 1942," *56 Harv. L. Rev.* 742 (1943).

The powers of appointment area was again sweepingly revised by the Powers of Appointment Act of 1951, whose rules are carried forward without change by §2041 of the 1954 Code. The 1951 Act not only rejected in large part the underlying philosophy of the elaborately drafted 1942 statute, but also applied the new rules retroactively for estates whose decedents died between 1942 and 1951.

The reasons for the extensive changes in 1951 were set out as follows by Guterman, "The Powers of Appointment Act," 29 *Taxes* 631, 632 (1951):

> The 1942 amendments were designed to give recognition to the fact that broad powers of appointment, even though not within the common law definition of a general power of appointment, were substantially equivalent to ownership. The amendments came about as a result of the incongruity of treatment of this type of right of disposition of property as against other rights under the estate tax which had been swept into the category of substantial equivalent of ownership. The form of the 1942 amendments

created certain burdens in dealing with powers of appointment which were not consistent with the general recognition of their importance and utility in the disposition of property. Thus, for example, the amendments granting immunity from taxation to a nonbeneficial power exercisable by a fiduciary were found to preclude in many cases, except under the most awkward limitations, the naming of executors and trustees who might be closely related to the decedent. Because such fiduciaries frequently had some kind of contingent interest in property subject to the power, there was a possibility of estate tax on the property subject to the power in the fiduciary's estate. In some cases, will draftsmen were impelled to exclude the participation of such close relative in the exercise of any power and to confine the exercise of such power to so-called disinterested trustees, that is, usually persons unrelated to the decedent. This problem was aggravated by the fact that a mere right to invade principal in favor of a beneficiary was by regulation swept within the category of a power of appointment, so that the common provision in a will of this kind created serious dangers of taxation, unless the particular beneficiary came within the limited statutory group in whose favor powers could be held without estate taxation or, as indicated above, unless the right to act in favor of the beneficiary was confined to disinterested trustees. The question of how remote an interest a fiduciary might have and still be subject to the danger of estate tax on a fiduciary power became a subject of much discussion and controversy. This area obviously called for a statutory change.

Another problem that arose in connection with the 1942 amendments was the absolute subjection to taxation of any power in a case where the donee of the power created a further power. This provision was primarily designed to avoid, without violating, the provisions of certain state laws whose rules against perpetuities permitted the indefinite creation of powers of appointment from generation to generation.* In this way property could be indefinitely taken out of subjection to estate tax. In the effort to circumvent this result, certain other types of dispositions were swept within the purview of estate taxation. For example, where the donee of a properly limited power otherwise nontaxable exercised such power by the creation of a trust and provided that the trustee should have the right in his discretion to pay over principal to the beneficiary, the otherwise tax-free power of appointment was rendered taxable, since such right to pay principal is classified as a power of appointment. This result would appear not to have been within the intended purpose of this provision of the law and created a limitation unrelated to tax avoidance and contrary to accepted methods of draftsmanship of wills and trusts.

See also Craven, "Powers of Appointment Act of 1951," *65 Harv. L. Rev.* 55, 61–64 (1951), which contains an interesting account of the important role played by the American Bar Association in securing enactment of the 1951 Act.

The 1951 Act dealt separately with powers created on or before October 21, 1942—the period when the statute spoke only of "property passing under a general power of appointment exercised by the decedent"—and those created after that date.

Before we turn to the distinction between pre- and post-1942 powers, a fundamental premise common to both should be noted: only "general powers of appointment," as defined, are subject to tax. The 1942 statute, as just stated, proceeded on the assumption that the donee of a power should in general be taxed if he had any control over appointive property; the only exceptions were for powers to appoint only among specified close relatives and for powers that were "fiduciary" in nature. The 1951 Act adopts the fundamentally contrary premise that the property should be taxed in the donee's estate only if he had a power to

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* See Leach, "Powers of Appointment," 24 *A.B.A.J.* 807, 809 (1938), §2041(a)(3), 1954 Code. [Ed.]

appoint to himself, his estate, his creditors, or his estate's creditors. Any power not capable of such exercise, no matter how extensive the donee's control over the property, is not a "general power of appointment" under § 2041, and hence may be held, exercised, or released free of tax. What is the justification for imposing an estate tax under § 2038 on trusts which the decedent had a non-beneficial power to alter or amend (see *Porter* v. *Commissioner*, *supra*, p. 1061), while exempting property subject to identical control under a power of appointment? Note that §2041(b)(1) reaches only powers that are "exercisable" in favor of the decedent or his creditors. What if the donee may appoint within a class that includes his wife and minor children? See Regs. 105, Sec. 81.24(a)(3), on powers "exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit."

Certain powers that would otherwise be general powers are exempt by subsections (A), (B), and (C) of §2041(b)(1). These are:

(A) Powers to invade property that could be exercised by the decedent for his own benefit only under "an ascertainable standard relating to [his] health, support or maintenance." Why this exception? Litigation under §2038 (see *Jennings* v. *Smith*, *supra*, p. 1079) and under §2055 (*infra*, pp. 1210–16, see also Regs. 105, Sec. 81.24(a)(3), second paragraph) foreshadows difficulty with this provision and casts doubt upon the draftsmen's belief that they have made "the law simple and definite enough to be understood and applied by the average lawyer." Will a power be exempt if the donee may exercise it "to maintain himself in the style to which he has been accustomed"? In the style to which his family background entitles him "to become accustomed"? In the style "that an annual income of $100,000 would assure"? In *Barritt* v. *Tomlinson*, 129 F. Supp. 642 (S. D. Fla. 1955), it was held that an income beneficiary's right "to use all or any part of the principal as she may see fit" was, under local law, exercisable only "to that extent which was necessary for her support," and that it was a restricted power under §2041(b)(1)(A). See also Rev. Rul. 243, 53–2 C.B. 267.

(B) Pre-1942 powers that are exercisable only in conjunction with another person. This exclusion carries forward the conclusion of a few courts that, under the pre-1942 statute, a joint power could not be a general one.

(C) Post-1942 joint powers that are exercisable only in conjunction with the creator of the power or a person having a substantial adverse interest. If the other person or persons whose consent is required has no adverse interest but is nevertheless a potential appointee, only an appropriate fraction of the property is taxed to the decedent donee. The concept of a substantial adverse interest—hitherto unknown to the estate tax statute—is given some definiteness by §2041(b)(1)(C)(ii), but for the most part its meaning will have to be developed by analogy from the income and gift tax law. See *Camp* v. *Commissioner*, *supra*, p. 1089.

Bearing in mind that only property subject to a general power, as just defined, is taxable in any event, we may now turn to the differences under the 1951 Act between pre-and post-1942 powers:

(1) *Powers created on or before October 21, 1942.** Property subject to these

* For the date of "creation" of a power of appointment, see §2041(b)(3); Rev. Rul. 278, 53–2 C.B. 267.

powers is taxed only if the power is *exercised* by the decedent by will or by other testamentary disposition. Is a power "exercised" if the donee of the power provides that the property shall go to the takers in default? If the appointees renounce? See *Wilson* v. *Kraemer*, 190 F.2d 341 (2d Cir. 1951), cert. den. 342 U.S. 859; *Moran's Estate* v. *Commissioner*, 16 T.C. 814 (1951). The student should contrast the divergent approaches of the 1942 and 1951 amendments to pre-1942 powers. Both recognized that some allowance should be made for powers created when the pre-1942 statute was in effect. The 1951 Act provides for a tax only if the power is exercised; the 1942 Act provided for a tax whether the decedent exercised the power or died without exercising it, but allowed a limited period (which, however, was periodically extended by Congress) for releasing the power free of gift tax. The 1951 Act also provides that if a general power has been appropriately "whittled down" to a non-general power by partial release during the donee's lifetime, his subsequent exercise of the power as thus reduced will not be taxable under certain conditions. Section 2041 (a)(1), last sentence. See Nossaman, "Release of Powers of Appointment," 56 *Harv. L. Rev.* 757 (1943), McCoid, "The Non-General Power of Appointment—A Creature of the Power of Appointment Act of 1951," 7 *Vand. L. Rev.* 53 (1953); Freeman, "If This Be Simplification—A View of Pre-1942 Powers of Appointment and the 1954 Internal Revenue Code Section 2041," 40 *Corn. L. Rev.* 500 (1955).

(2) *Powers created after October 21, 1942.* Property subject to a post-1942 power will be taxed if the power is either possessed at death or exercised or released by testamentary disposition. To this extent, the 1951 Act accepts the premise of the 1942 amendments (and of such other portions of the Code as §2038) that the estate tax should concern itself with the decedent's control over property, whether he exercised it affirmatively or not. On the other hand, §2041(a)(2) provides that a disclaimer or renunciation of a power shall not be deemed a release, although in point of fact a disclaimer or renunciation, like a release, may be a method of transmitting the property to those whom the donee of the power wishes to benefit. The Congressional reports on the 1951 Act state that the disclaimer or renunciation "must be made within a reasonable time after learning of the power."

Section 2041(b)(2), added by the 1951 Act, deals leniently with the lapse of certain powers of appointment. It may come to have a substantial impact upon estate planning. It sets out as a general principle that the lapse of a power of appointment shall be treated as a release of the power. What would be the tax consequences, under §2041(b)(2), of these facts: The decedent was the income beneficiary for life of a trust of $200,000 and he had, in addition, the right to withdraw $50,000 from the corpus, this power to lapse on his reaching the age of 50; he died at 65 without having exercised his power. What would be the tax consequences of these facts in the absence of §2041(b)(2)?

The area in which §2041(b)(2) will be most important is the trust under which a widow or child is the income beneficiary with a power to withdraw, say, $5,000 per year. What will be included in the gross estate of the widow or child? What would the result have been if §2041(b)(2) had not been enacted? The purpose of this provision is to permit flexibility to be introduced into trust instruments, without tax cost, where the settlor of a trust is afraid that the income alone may prove to be insufficient for the income beneficiary's needs. See *supra*, p. 983. Query: Can this tax-free flexibility be reconciled with the Act's policy of otherwise treating the donee of a general power of appointment as an absolute

the same result by giving to the income beneficiary a power of appointment restricted under §2041(b)(1)(A)?

As stated earlier, §2041(b)(1) defines the term "general power of appointment" to mean "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." Suppose the power is exercisable only in favor of a restricted class, such as the donee's nieces and nephews, but in default of appointment, the property will go to the donee's estate. With such a power, the donee has as much freedom as though he could appoint to his estate. Is it a "general power of appointment"? If he dies without exercising the power, can the property be included in his gross estate under §2033, *i.e.*, does he have an "interest therein . . . at the time of his death"? If he exercises the power in favor of his nieces and nephews in contemplation of death, has he made a "transfer" of an "interest" in property under §2035(a)? In this connection, consider again the *Safe Deposit & Trust Co.* case, *supra*, p. 973.

A somewhat related problem is presented by the so-called "reverse power." Suppose the decedent was the remainderman of a trust created by his father, with the power to advance principal to the life beneficiary. If the decedent does not exercise his power, the remainder interest would become part of his gross estate on his death. Assume that, in recognition of this fact and in contemplation of death, he advances the entire principal to the life beneficiary. Could this power to advance principal to the life beneficiary be treated as a "general power of appointment" under §2041(b)(2) because the remainderman or his estate would receive the corpus outright if he did not exercise the power? If not, is there any other basis for including the appointive principal or some part of it in his estate? Similar questions would arise if the decedent had been the life beneficiary of the trust with the power to advance principal to the remainderman. See Johnson, "Powers of Appointment," 29 *Taxes* 965, 977–78 (1951).

In the section on life insurance, we saw that under the 1954 Code the proceeds of a policy on the life of the decedent are includible in his estate if he possessed any of the incidents of ownership at the time of his death, no matter who paid the premiums. Suppose the husband's life is insured under a policy obtained and paid for by the wife, and the husband has the power to change the beneficiary with the wife's consent. Will the proceeds be included in the husband's estate under §2042? Note that a power to appoint with the consent of the creator of the power is not a "general power of appointment" under §2041(b)(1)(C)(i). Note also that a power to appoint property is not a "general" power under § 2041(b)(1) if the donee cannot benefit himself. Is the power to designate an insurance beneficiary from within a class of persons an "incident of ownership" that will bring the proceeds into the insured's estate under §2042(2)? Is there any reason to tax the insured who has not paid for the policy because he possesses an incident of ownership if a comparable power of appointment would not result in an estate tax? Can the strict "incidents of ownership" rule of §2042(2) be avoided by placing the policies in trust, designating the trustee as the beneficiary, and giving the insured a non-general power to appoint the corpus of the trust? See *Estate* of *Karagheusian* v. *Commissioner*, 23 T.C. No. 102 (1955).

Inclusion of appointive property in the donee's gross estate obviously increases the tax burden on his estate. Under the 1951 legislation, property is included only if the donee could have appointed to himself or his creditors; thus the donee can avoid unfairness to his heirs and legatees by exercising the power for the benefit

cluding the appointive property. But, as indicated above, the 1942 legislation sometimes reached powers of appointment that could not be exercised by the donee for his own benefit. For this reason, the 1942 statute allocated part of the estate tax burden to the appointive property. 1 Paul, *Federal Estate and Gift Taxation* (1946 Supp.) p.289. The provision has been carried forward as §2207 of the 1954 Code. It is similar to the provision allocating the estate tax burden caused by the proceeds of life insurance to the beneficiaries thereof, *supra*, p. 165 n.

Before 1954, property subject to a power of appointment would take on a new income tax basis on the death of the donee of the power if it passed under a general power exercised by will. Section 113(a)(5) of the 1939 Code, carried forward as § 1014(b)(4) of the 1954 Code. Section 1014(b)(9) of the new Code, however, extends the principle of a stepped-up (or stepped-down) basis to any property acquired "from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment)" if the property was includible in the donee's estate. Would this cover property acquired when the decedent-donee released his power?

See generally Craven, "Powers of Appointment Act of 1951," 65 *Harv. L. Rev.* 55 (1951), Guterman, "The Powers of Appointment Act," 29 *Taxes* 631 (1951), Lowndes, "Estate Planning and Powers of Appointment," 30 *N. C. L. Rev.* 225 (1952), Bowe, "Estate Tax Planning Under the Powers of Appointment Act of 1951," 5 *Vand. L. Rev.* 197 (1952). The Guterman article poses this interesting question: If the donee of a power released it in whole or in part during the period 1942-51 because of his expectation (now proven unfounded) that the 1942 legislation would otherwise impose a tax on his death, may he now revoke the release as induced by a mistake of fact?

Gift Tax

Before 1942, there was no specific mention of powers of appointment in the gift tax provisions of the Code. A leading case held that the exercise of a power of appointment did not constitute a taxable gift by the donee, primarily because the Supreme Court had held in the *Field* case, *supra*, p. 975, that appointive property was not includible in the donee's estate in the absence of specific legislation. *Commissioner* v. *Walston*, 168 F.2d 211 (4th Cir. 1948). But other cases pointed in the opposite direction and the regulations adhered to the approach of these cases. *Cerf* v. *Commissioner*, 141 F.2d 564 (3d Cir. 1944); *Richardson* v. *Commissioner*, 151 F.2d 102 (2d Cir. 1945), cert. den. 326 U.S. 796; Regs. 108, Sec. 86.2(b)(7). In 1942, the gift tax statute was amended to provide explicitly· "An exercise or release of a power of appointment shall be deemed a transfer of property by the individual possessing such power." The new statute went on to provide that the term "power of appointment" did not include powers of the type immune from estate tax under the 1942 law, *i.e.*, powers to appoint only within the donor's or donee's family or to charities, and so-called fiduciary powers. Just as property subject to such limited powers was not part of the donee's gross estate for the estate tax, so it could be routed during the donee's lifetime to an

appointee (by exercise of the power) or to a taker in default (by release of the support her.

Quite naturally, the 1951 Powers of Appointment Act swept aside the 1942 provisions governing the gift tax liability of the donee of a power of appointment and substituted principles (embodied without change in § 2514 of the 1954 Code) in harmony with the new estate tax provisions. The gift tax now applies, like the estate tax, only to a "general power of appointment," and this term is defined in the same way for both taxes. Next, §2514(b) provides that the exercise or release of a post-1942 power "shall be deemed a transfer of property by the individual possessing such power." (Special provision is made by §2514(a) for pre-1942 powers.) Finally, §2514(e) brings the gift tax into harmony with the estate tax with respect to lapsed powers.

If the donee of a power may appoint only to his nieces and nephews but his estate is the taker in default, does he make a gift by exercising the power in favor of a niece or nephew? We considered earlier, *supra*, p. 1185, the question whether the power is a "general power of appointment." The "reverse power" also poses gift tax questions that are parallel to the estate tax questions already raised. Does the income beneficiary of a trust who can advance principal to the remainderman make a gift when he exercises his power? If so, how is the amount to be measured? What of a remainderman who exercises a power to advance principal to the life beneficiary?

If *A* is a legatee under the will of *B* and renounces his legacy, does he thereby make a gift for gift tax purposes to the residuary legatee or other person who takes the renounced property? In a leading case, it was held that a renunciation by a legatee, in contemplation of death, of an interest in his wife's estate was not a "transfer of property" for estate tax purposes:

> The decedent never owned nor had control of the property as donee. All that he had was a right to accept. Coupled with this right was an equal right to reject. Either could be exercised so long as the estate was in administration. He did reject The government had no fixed prior right such as a precedent judgment creditor might have had. . . . What it did was to collect a tax, not upon the transfer of an interest in property, but upon the exercise of a right to refuse a gift of property. This we think it had no right to do. (*Brown* v. *Routzahn*, 63 F 2d 914, 917 (6th Cir. 1933), cert den. 290 U.S. 641.)

The case has often been cited, but other courts have ordinarily applied it only if the taxpayer's renunciation was unequivocal; if there was a partial acceptance of the gift, renunciation of the balance may be treated as a transfer for gift or estate tax purposes. *Cerf* v. *Commissioner,* 141 F.2d 564 (3d Cir. 1944); *Morton's Estate* v. *Commissioner,* 12 T.C. 380 (1949). It has also been held that an intestate successor's renunciation is a gift if under state law title vested in him immediately on the intestate's death. *Hardenbergh* v. *Commissioner,* 198 F.2d 63 (8th Cir. 1952), cert. den. 344 U.S. 836. In the *Bergan* case, *supra*, p. 1161, it was argued that Miss Bergan had "renounced" her interest in Mrs. Johnson's estate (except for the $50,000 of bonds) within the meaning of *Brown* v. *Routzahn,* but the court held that she had transferred this share as consideration for Mrs. Goggin's promise to power) without payment of gift tax by the donee.

Should all renunciations be treated like exercises of a general power of appointment? Note that § 2514(b) provides that a renunciation or disclaimer of a power

of appointment shall not be treated as a release, *i.e.*, it is not a taxable gift under § 2514. Could this action constitute a taxable gift under some other provision of the gift tax law? See Canale and Cooper, "Will Renunciation of a Bequest or Failure to Claim a Statutory Share Constitute a Taxable Gift?" 2 *Vand. L. Rev.* 287 (1949); Note, 63 *Harv. L. Rev.* 1047 (1950); Roehner and Roehner, "Renunciation As Taxable Gift—An Unconstitutional Federal Tax Decision," 8 *Tax L. Rev.* 289 (1953).

The statute does not state whether the *creation* of a power of appointment is a taxable gift. If *A* creates in *B* a power to appoint to himself, or if he gives *B* a power to appoint to others and names *B* as the taker in default, has *A* made a gift? If *A* confers on *B* the power to appoint to *C* or *D*, naming *X* as the taker in default, has *A* made a taxable gift to *B*, *C*, *D*, and/or *X*? Is an exclusion allowed under § 2503(b)?

Chapter 14

VALUATION OF PROPERTY

Section 2031(a) provides that the value of the decedent's gross estate "shall be determined by including the value . . . at the time of his death of all property . . ." But §2032 permits the estate, if the executor so elects, to be valued as of one year after the decedent's death.

The Code does not prescribe a method of arriving at the "value" of included property, except for a vague provision for unlisted securities.* The regulations on the subject, however, are rather elaborate; they are introduced by this general statement (Regs. 105, Sec. 81.10(a)):

> The value of every item of property includible in the gross estate is the fair market value thereof at the time of the decedent's death; or, if the executor elects in accordance with the provisions of section 81.11, it is the fair market value thereof at the date therein prescribed [the optional valuation date—one year after death—mentioned above] or such value adjusted as therein set forth. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. The fair market value of a particular kind of property includible in the gross estate is not to be determined by a forced sale price. Such value is to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond. All relevant facts and elements of value as of the applicable valuation date should be considered in every case.

The Code is equally laconic in respect of the gift tax; §2512(a) provides: "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." The principles of valuation set out in the gift tax regulations (Regs. 108, Sec. 86.19) are virtually identical with those prescribed by the estate tax regulations.†

Active stocks and bonds. The regulations provide that if stocks and bonds are listed on a stock exchange, are dealt in through brokers, or "have a market," their value shall be determined by taking the mean between the highest and lowest selling prices on the valuation date or, if there were no sales on that date, by taking the means for the nearest dates before and after the valuation date and interpolating for the valuation date. If sales prices are not available for a date within a reasonable period from the valuation date, bid and asked prices may be substituted.

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* Section 2031(b), said to be declaratory of earlier law, *Colonial Trust Co.* v *Kraemer*, 63 F.Supp. 866 (D.C. Conn., 1945).

† The gift tax regulations omit the last two sentences, possibly because §2031(b), *supra*, has no counterpart in the gift tax statute.

It is also provided that if the value as "determined on the basis of selling or bid and asked prices . . . does not reflect the fair market value thereof, then some reasonable modification of such basis or other relevant facts and elements of value shall be considered in determining fair market value" According to Paul, this provision is "a guarded recognition of the taxpayer's right to prove the influence upon value of the amount of stock holdings subject to valuation." Paul, 2 *Federal Estate and Gift Taxation*, §18.27 (1942). See *Commissioner* v. *Stewart*, 153 F.2d 17 (3d Cir. 1946). In a number of cases taxpayers have been successful in establishing a "fair market value" below the quoted prices *Havemeyer* v. *United States*, 59 F.Supp. 537 (Ct.Cl., 1945), cert. den., 326 U.S. 759 (value for gift tax of one stock, $25 instead of quoted price of $28; of another, $22 as against $24.50), *Helvering* v. *Maytag*, 125 F.2d 55 (8th Cir. 1942), cert. den., 316 U.S. 689 ($3.10 as against $4 75); *Helvering* v. *Safe Deposit & Trust Co.*, 95 F.2d 806 (4th Cir. 1938) ($35 as against $44); see also Montgomery, *Federal Taxes—Estates, Trusts and Gifts*, 1947–48, pp. 604–6. Cases of this type have stressed the depressing effect on the market of a sale of a large block of stock. Why is this fact relevant? What of the possibility of realizing the price quoted on the valuation date by engaging a "skillful broker" to dispose of the stock over a period of time? See *Bull* v. *Smith*, 119 F.2d 490 (2d Cir. 1941); see also *Newberry* v. *Commissioner*, 39 B.T.A. 1123, 1130–1 (1939). What if such a marketing process could obtain *more* than the quoted price? Note that the regulations speak of "a willing buyer and a willing seller." Granted that a large offering would depress the market, what of the fact that a large demand—"a willing buyer"—would improve it? See Freeman and Vinciguerra, "Blockage Valuation in Federal Tax Law," 94 *Univ. of Pa. L. Rev.* 365 (1946); Barrett, "Valuation of Stocks by the Blockage Rule," 29 *Taxes* 465 (1951).

Does the portion of the regulations quoted in the preceding paragraph permit the taxpayer (or the Commissioner) to show that, although the stock could have been sold without difficulty at the quoted price, the estate tax value should be lower or higher because the market price was influenced by groundless hopes or fears of investors?

Inactive stocks and bonds. When there is no recognized market for the securities, the regulations (Regs. 105, Sec. 81.10(c)) provide that

> . . . the value is to be arrived at by giving consideration to the soundness of the security, the interest yield, the date of maturity, and other relevant factors, and, in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Among such other relevant factors to be considered are the values of securities of corporations engaged in the same or a similar line of business which are listed on an exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case.

The student will recognize that he is here being beckoned into a morass. Some guideposts, together with a frank warning of the treacherous underfooting, will be found in 2 Paul, *Federal Estate and Gift Taxation* (1942) Chap. 18, *passim*. And see 2 Bonbright, *The Valuation of Property* (1937), Chapter XXI, Sprecher, "The Valuation of Stock in a Closely-Held Corporation for Federal Gift and Estate Tax Purposes," 31 *Ky. L. J.* 325 (1943), Rice, "Valuation of Close Held

Stocks: A Lottery in Federal Taxation," 98 *U. of Pa. L. Rev.* 367 (1950, Johnson, Shapiro and O'Meara, "Valuation of Closely-Held Stock for Federal Tax Purposes· Approach to an Objective Method," 100 *ibid.* 166 (1951). See also, for an elaborate statement of the government's views, Rev. Rul. 54–77, 54–1 C.B. 187.

Like the valuation of inactive securities, the valuation of the decedent's individual proprietorship or interest in a partnership is no easy task. The value of good will is especially troublesome, as it is in the case of stock.

Other property. The regulations deal also, though more briefly, with the valuation of real estate, notes, and household and personal effects, and contain tables for computing the value of annuities, remainders, *etc.*

Income tax basis of inherited property. For the effect of the estate tax valuation on the beneficiary's income tax basis, see *supra*, p. 968.

Optional valuation date. Section 2032 permits the executor to value the estate as of one year after the decedent's death, instead of using the value on the date of death. This provision, enacted in 1935, is intended to prevent the confiscation of estates when market values decline abruptly after the decedent's death. The House version of the 1954 Code would have permitted the optional valuation date to be used only if there was a decline of one-third of the estate's value between the date of death and the optional date. The Senate eliminated this restriction, and §2032 as enacted is a restatement of §811(j) of the 1939 Code.

The provision produces a welter of difficulties, partly because adjustments must be made for property that has been distributed or sold in the year after death and for property that "is affected by mere lapse of time." Section 2032(a)(2) and (3). What if an extraordinary cash dividend is declared, with the consequence that the shares owned by the estate are of substantially less value on the optional valuation date than on the date of death? What of stock dividends? See Regs. 105, Sec. 81.11(4). Where the optional valuation date is elected by the executor, it is also controlling in determining the beneficiary's income tax basis under §1014(a). May the executor use whichever date produces the *higher* value, so as to produce a higher income tax basis for the beneficiaries of the estate? The Internal Revenue Service apparently believes that he can. Rev. Rul. 55–333, 55–1 C.B.__.

See *Maass* v. *Higgins*, 312 U.S. 443 (1941).

BONBRIGHT
THE VALUATION OF PROPERTY

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With death duties as with other taxes, one properly looks to the economic or ethical basis of the tax for light on the meaning of "value of the property." But, perhaps more than with any other tax, there is the greatest difference of opinion as to what this basis is. Indeed, as judgment has become more nearly unanimous that the tax is socially desirable, it has become more divergent as to *why* it is desirable. A recent staff report to a Joint Congressional Committee lists nine different economic principles on which various experts have defended the death

taxes. These principles include various forms of the old doctrines of "benefit" and of "ability to pay," with additional defenses based on the argument for diffusion of wealth and on the desirability of handicapping the acquisition of wealth except as a reward for the accomplishment of socially useful work. The prevalent view among economists is that no single principle can be accepted to the exclusion of all others, and that the merits of any particular death duty must be judged by reference to a host of probable economic and social consequences.

This last conclusion does not make the task of the theorist an easy one. But so far as concerns the choice of a proper basis of appraisal, the problem is not quite so complicated as might be assumed. For the appraisal is only one of the factors determining the amount of the tax, and its proper basis is not necessarily affected by the precise rationale of the tax. For example, the assumed utility of an inheritance tax as a preventive of enduring family fortunes would hardly suggest a different basis of valuation from that suggested by the principle of "ability to pay."

Without taking a positive position, therefore, on the economic philosophy of the death duties, one may still reach tenable conclusions as to the proper methods of valuation. The basis for such conclusions is to be found in the fact that the burden of the tax falls on the beneficiaries, even if the tax is paid by the executors out of the estate as such. "Value of the property" should therefore be interpreted to mean (or to be an approximate index of) that value which is significant to the beneficiaries—in short, a special form of the concept of "value to the owner" Clearly, the worth of the estate to the decedent is of no consequence here. But equally truly, its market value, in the strict sense of the price at which it might be sold to any outside party, is irrelevant save as a possible measure of the value of the property to those who inherit it.

This last assertion, however, needs further defense, since it would be vigorously denied by many writers, and since it seems to run counter to current statute law and common law. The point is made that a death duty, unlike an annual levy under the general property tax, is usually paid by a liquidation of a portion of the estate itself—often a very considerable portion. Moreover, much of the decedent's remaining property must be sold by the executors, partly as a means of paying the expenses of administration, partly as the only feasible method of distribution among the beneficiaries. If the estate has been left in trust, still further liquidation may be called for in order to make the investments qualify for trust funds. Under these circumstances, it is argued, an appraisal under the death duties requires a strict adherence to the standard of market value, defined, not in the traditional but vague sense of a "fair selling price," but as the price, fair or unfair, which the property would actually command if presently offered for sale in the manner available to executors and trustees.

This position has much force—so much so as to justify fewer departures from a market-value standard than are warranted in most other fields of taxation. But it does not constitute an argument for the abandonment of value to the owner as the *ideal* basis of valuation. Instead, it amounts in effect to the sound contention that this latter value is often *measured* by market value, without reference to the special adaptability of the property to the various beneficiaries. For if we grant that the executors or trustees will in fact sell the assets of the estate to

outsiders, we must also grant that these assets are worth nothing to the beneficiaries except for their realization value.

Because a valuation based on market price is so *generally* the best available measure of the value of the assets to the beneficiaries themselves, its adoption is justified as a matter of administrative convenience even in many instances in which the assessor has reason to believe that the assets will not in fact be liquidated and that they will come into the possession of beneficiaries to whom they will have a value in excess of their sale price. A frankly crude but workable basis of assessment is preferable to a theoretically refined basis, too complex for ready administration.

But with certain types of inheritances, the discrepancy between the price at which the property could be sold to outsiders, and the value of the property to its beneficiaries, is so wide that it cannot be ignored; and here the market-value standard should be abandoned. The most conspicuous examples in point are those of life estates, remainders, and other forms of divided interests that are literally or practically unsalable. In practice, properties of this nature are valued on actuarial principles discussed in a later section. These appraisals do not reflect market values. Their validity rests solely on their merits as a rough-and-ready measure of the value of these unmarketable properties to their inheritors; and this point is recognized, in effect if not in words, by the opinions of the courts.

Even with marketable forms of property, the assessor is often faced with a significant discrepancy between the price at which the property could be sold and its special value to a beneficiary. An example in point is to be found where the estate contains a large block of stock, which may be readily sold only at a discount from the current market price of 100-share lots, but which may be worth even more than this current market price to the beneficiary, for purposes of controlling an enterprise. This situation gives rise to the "blockage problem," discussed later. Here we are noting simply that, even under the death duties, market value, defined in any one precise sense, is not the *ideal* basis of valuation.

SPITZER v. COMMISSIONER

U.S. Court of Appeals, Eighth Circuit, 1946
153 F.2d 967

Before SANBORN, THOMAS, and RIDDICK, Circuit Judges.

RIDDICK, Circuit Judge.

On October 15, 1940, petitioner gave to his wife 75 shares of common stock of the Forest City Manufacturing Company. In his gift tax return for the calendar year 1940 petitioner reported the stock at a value of $186 a share. Petitioner intended the value of the stock to be reported at $286 a share, the book value as of December 31, 1939. He admits liability for whatever difference in tax results because of this error, caused by a mistake made in calculation by the accountant who prepared the gift tax return. The commissioner fixed the value of the stock at $500 a share and assessed a deficiency. The Tax Court approved the Commissioner's determination. We are asked to reverse on the ground that

the finding of the Tax Court as to the value of the stock has no support in the evidence and no reasonable basis in law.

The Forest City Manufacturing Company, a Missouri corporation with principal offices in St. Louis, was organized prior to 1918. In 1919 all of its capital stock was purchased by petitioner Harry H. Spitzer who became president, Simon Spitzer who became vice president, and A. H. Sincoff who became secretary These men are still executive officers of the company and together with their respective families own substantially all of its capital stock. The company has a capitalization of $300,000, represented by 1,000 shares of common stock of a par value of $100 and 2,000 shares of seven per cent preferred stock of a par value of $100 a share. Prior to 1939 the company was engaged in the manufacture of cotton house dresses and became one of the largest manufacturers engaged in this business in the United States. Since 1939 it has engaged exclusively in the manufacture of junior misses dresses.

The business in which the company is engaged is subject to wide fluctuation and is extremely hazardous. A mistake in the style design of its line of dresses for one season might be sufficient to wreck its business, and the effects of such a mistake may be seriously felt for years in the business of the most successful company. No stocks of companies engaged in the same business as that of the Forest City Manufacturing Company are listed for trading purposes with any stock exchange or traded locally in over-the-counter sales. There is no evidence of sales of stock in the Forest City Manufacturing Company. From the going quotations of other securities in similar but not so hazardous types of business in St. Louis and in other parts of the country in 1940 in both over-the-counter and on the market transactions, it was most usual to find them selling at five or six times their average earnings over a five-year period. The price in some sales was as high as eight times average earnings for the period stated. The listed markets for securties in 1940 were uncertain and unsettled as the result of the war in Europe. These markets suffered a collapse in May 1940 and, although they recovered somewhat in the summer of that year, they faced a difficult situation throughout the year.

From 1930 through 1940 invested capital of the company increased from $200,000 to $300,000, its net profit after taxes from $16,000 to $128,000, its net sales from approximately $2,000,000 to approximately $4,500,000; and earnings available for dividends on common stock from $9,000 to $114,000. The average earnings for the company available for dividends on common stock for the five years ending December 31, 1940, were $68 a share, and the average dividend paid on the common stock during this period was $47 a share. There was no evidence offered to indicate the comparative record of companies engaged in similar business over the five-year period. The trend in the company's earnings available for dividends on the common stock had been steadily upwards since 1936. For the four years ending in 1940 these earnings had averaged approximately $82 a share. After the company changed from the manufacture of women's cotton house dresses to junior misses dresses in 1939, its average earnings for that year and for 1940 available for common stock were approximately $103 a share. Dividends paid in 1939 were $90; in 1940, $75. As noted above, the book value of the common stock as of December 31, 1939, was $286. The 1940 balance sheet of the company indicates that at the time of the gift on the 15th day of October

1940, and prior to the declaration of an annual dividend of $75 a share on the common stock, the book value of the common stock was approximately $400 a share after allowing for the payment of dividends on the preferred stock for the entire year. The book value of common stock as shown by the company's balance sheets is apparently conservative, certainly not excessive.

It would appear from what has been said that the Tax Court's finding of the market value of the common stock at the time of the gift was supported by ample evidence. But petitioner asserts that the market value of the stock at the time of the gift was fixed by an agreement between the company and all of its stockholders, executed in May 1940; and that in any event the Tax Court refused to give any weight to the agreement as a factor important in the determination of the market value of the stock at the time of the gift, and has ignored the testimony of a qualified expert witness for the petitioner who testified that at the time of the gift the fair market value of the common stock of the company was not in excess of two-thirds of its book value on December 31, 1939.

At the time of the execution of the contract relied upon by petitioner, each of the three executive stockholders held 310 $\frac{1}{12}$ shares of the 1000 shares of the common stock of the company. The purpose of the contract was to insure the continued control of the corporation by these executive stockholders or by the survivors of them. The voting power of all the common stock of the corporation was vested by the contract in the three executive stockholders or the survivors of them. The right of the holders of any of the common or preferred stock of the corporation, other than the executive stockholders, to pledge or encumber their shares was prohibited without the consent of the executive stockholders. The corporation, the executive stockholders, or the survivors of them were given the right to purchase the company's outstanding capital stock at prices fixed by the provisions of the contract and upon certain contingencies expressed in the contract.

On the death of one of the executive stockholders, the corporation was required to purchase from the then holders or their personal representatives all the stock, common or preferred, owned by the executive stockholder at the time of the execution of the contract, or to liquidate, as the surviving executive stockholders might elect. In the event that the surviving executive stockholders decided to purchase from the then holders the stock held by the deceased executive stockholder at the date of the contract, the purchase was to be consummated within three months after his death. The purchase price of the common stock was fixed at its book value as determined by the regular audit of the books of the corporation as of the close of the last preceding fiscal year if the death of the executive stockholder occurred within the first ten months of the fiscal year, or at the book value at the close of the then current fiscal year if the death occurred during the last two months of the fiscal year. The fiscal year of the corporation was the same as the calendar year. If the book value as of the close of the last fiscal year preceding the death of the executive stockholder became the purchase price of the stock, provision was made for adjustment in the purchase price by giving consideration to any substantial changes in capital account which might have taken place in the interim between the close of the preceding fiscal year and the date of the consummation of the purchase, including the maturity of insurance carried upon the life of the deceased executive stockholder, and to certain other accounting factors not important here. At the time of the gift in question the

corporation carried insurance upon the life of petitioner in the amount of $100,000. The purchase price of the common stock was to be paid in cash to the extent of the proceeds of the insurance upon the life of the deceased executive stockholder, the balance to be represented by unsecured notes of the corporation, payable over a period of three years, bearing interest at six per cent, and subject to prepayment and to acceleration on default.

In the event the corporation was unable to purchase the stock of a deceased executive stockholder, the contract provided that the purchase should be made by the corporation to the extent that such purchase was lawful, and that the surviving executive stockholders should purchase the remainder of the stock upon the same terms as were provided for purchase by the corporation.

On the death of the second executive stockholder, the corporation was required to purchase upon the same terms as set forth above from the then holders or their personal representatives all stock in the corporation owned by the deceased second executive stockholder or by his wife or lineal descendants at the time of the execution of the contract.

After first obtaining the approval of all the executive stockholders or the survivors of them, the corporation or any of the executive stockholders had the right to purchase any or all of the common or preferred stock held by any stockholder at any time upon notice of such intention to the holder of the stock. In the event of a purchase under this section of the contract, the stockholder was required to deliver his stock to the purchaser for a cash payment equal to the book value of the stock at the close of the fiscal year preceding the purchase. As of the close of the fiscal year in which a purchase under this section took place, the purchase price was fixed at the book value of the stock on such date, as shown by the audit of the books of the corporation, plus dividends payable or paid on common stock to holders of record after the date of the purchase and before the end of the fiscal year in which the purchase was made.

The contract also contained a provision that if any executive stockholder ceased to be an active officer of the company without the approval of the other executive stockholder or stockholders, the corporation or any of the executive stockholders or any combination of them should have the right to purchase all the common stock held by the inactive executive stockholder or by his wife or by his descendants or by any trust or estate for the benefit of any of them. The price to be paid for the stock under this section of the contract was to be determined in accordance with the provisions of the section stated above, and the right to make the purchase vested at any time after an executive stockholder became inactive.

The contract expired by its terms after the death of two executive stockholders and their obligations under the contract arising in connection with their deaths had been fulfilled. Otherwise, the contract was to continue in effect until terminated by the agreement of all the executive stockholders or the survivors of them or by the written irrevocable request of any one of the executive stockholders delivered to the others and to the corporation two years prior to the effective date of such termination.

Specifically the petitioner contends that, since the gift to his wife was made in the first ten months of 1940, the agreement executed by the stockholders was effective to fix the market value at the book value of the shares, which were the

subject of the gift, as of December 31, 1939, or at $286 a share. Giving this effect to the contract, petitioner contends that the Tax Court's decision upon the question of value of the stock was not in accordance with law.

We think it clear that the Tax Court was correct in its decision that the contract did not fix the value of the stock for gift tax purposes that the taxpayer contends. The cases relied on by petitioner have no application to the facts in the present case.

Helvering v. *Salvage*, 297 U.S. 106, affirming *Salvage* v. *Commissioner*, 2 Cir., 76 F.2d 112, was an income tax case which involved the determination of the fair market value of capital shares of a corporation. At the critical date the stock was subject to an option entitling the holder of the option to purchase the stock at a stated figure. It was held that in view of the option there could be no proper finding of fair market value on the critical date in excess of the option price. *Wilson* v. *Bowers*, 2 Cir., 57 F.2d 682, and *Lomb* v. *Sugden*, 2 Cir., 82 F.2d 166, involve the value of shares of corporate stock for estate tax purposes. In the *Wilson* case decedent's shares of stock in a closely held corporation were subject at his death to a contract between him and the other owners of the capital stock of the corporation, by the terms of which on the death of one of them either the others had the right to purchase the decedent's shares at a stated price at any time within four months after the qualification of the decedent's executors. It was held that the contract fixed the value of the capital stock for estate tax purposes in the amount stated in the contract. In *Lomb* v. *Sugden*, decedent at her death held the shares of stock subject to an agreement whereby none of the stockholders of the corporation could sell his stock without first offering the shares to the other stockholders at a limited price, and whereby, in the event of a stockholder's death intestate and without issue, his executors or administrators were required to offer the stock at the limited price to the other stockholders. The court held that the value of the stock for purpose of determining the Federal estate tax was the price fixed by the terms of the agreement. *Commissioner* v. *Bensel*, 3 Cir., 100 F.2d 639, and *Commissioner* v. *Child's Estate*, 3 Cir., 147 F.2d 368, also involve the determination of value of shares of corporate stock for estate tax purposes. In the *Bensel* case the stock was subject on the date of the death of the holder to an absolute option for its purchase at less than its market value. It was held that the price fixed in the option to purchase, not the fair market value of the stock, should be included in the estate for the determination of the estate tax. In *Child's Estate* the court declined to reverse the Tax Court's decision that the value of shares for estate tax purposes was $10 a share as fixed by an option for its purchase in effect at decedent's death, and not $100 a share, its market value. The contention of the Commissioner before the Tax Court was that, since the option had not been exercised at the time of decedent's death, its provisions were not entitled to be considered as a factor in determining the fair market value of the stock. The court denied this contention and refused to consider other arguments not advanced by the Commissioner before the Tax Court.

Plainly, all these cases are distinguishable from the facts in the present case. In the income tax case the value of the shares and the critical time for the determination of value were fixed by the option contract. In each of the estate tax cases the critical event, the death of the holder of the shares, which subjected the stock

to purchase for a price stated in the option, had occurred. In the circumstances of these cases it was plain that a purchaser could not be found for the shares at a greater price than that for which he would be compelled to sell immediately upon acquisition. In the present case petitioner at the time of the gift was 51 years of age, with a life expectancy of twenty years. When the gift was made no one could predict when the petitioner might die, or retire without the consent of the other executive stockholders. The critical event necessary to occur in order to bring into play the provisions of the contract fixing the price of the stock given by the petitioner to his wife had not occurred, and, by its terms, the contract might have been terminated long before the occurrence of the critical event. The point under discussion was clearly illustrated in *Commissioner* v. *McCann*, 2 Cir., 146 F.2d 385, decided by the same court which decided *Wilson* v. *Bowers*, and *Lomb* v. *Sugden*. The controversy was over the value of corporate shares for gift tax purposes. The taxpayer gave 2500 shares of stock to his wife on November 27, 1939. The book value of these shares as of December 31, 1939, was $36 a share. The taxpayer adopted this figure in reporting the gift. The Commissioner raised the value and assessed a deficiency. Under the company's by-laws no one but an employee might hold these shares. When his employment ended, the employee or his estate was required to sell and the corporation was required to buy all the shares at their book value. The taxpayer was the president of the company, holding more than two-thirds of the voting stock. His wife was an employee. The Tax Court refused to consider any other factor than the book value at the time of the gift because that was all that the donor could have sold the shares for and because he could have compelled the company to buy them at that price. The court of appeals reversed. After holding the *Wilson* and *Lomb* cases inapplicable to the facts before it, the court said (page 386 of 146 F.2d):

> . . . Nobody could know when the donor would retire or die, meanwhile he would be entitled to such dividends as were declared, and when he did retire or die, the book value of the shares would not be likely to bear much relation to what it was at the time of the gift. It is difficult enough to appraise the value of shares subject to such a restriction, but it is no step towards a solution to make the book value at the time of the gift the measure. . . . The fact that the price at the shareholder's retirement or death was fixed for both parties, did not prevent the shareholder from collecting any dividends declared before that time, nor did it change the fact that the book value at the time of the gift would presumably have no relation to that which would eventually fix the price. . . .

In support of its conclusion in the *McCann* case the court cited *Kline* v. *Commissioner*, 3 Cir., 130 F.2d 742, and *Krauss* v. *United States*, 5 Cir., 140 F.2d 510. In both of these cases a corporation had an option based upon book value to purchase a shareholder's stock if he died or retired. In each case the controversy was over a gift tax, and in each case the court held that the option price did not control the value of the shares for the determination of gift tax. See also *Heiner* v. *Gwinner*, 3 Cir., 114 F.2d 723.

We conclude that the most that can be said concerning the effect of the contract upon the fair market value of the stock at the time of the gift is that it was a factor to be considered by the Tax Court in appraising the stock for gift tax purposes. *Worcester County Trust Co.* v. *Commissioner*, 1 Cir., 134 F.2d 578. Plainly, the contract was not effective to fix the value at the time of the gift at the book value

of the stock as of December 31, 1939. To give to the so-called restrictive agreement the effect for which the petitioner contends requires that a provision be read into the contract which it does not contain. Petitioner made his gift in October 1940. If petitioner had died on the date of the gift, the provision fixing the price at which the corporation was required to buy the stock would have gone into operation. But the corporation was not required to purchase the stock in the event petitioner made a gift of it. At the time of the gift the corporation had that right only with petitioner's consent which was not given. It is no more possible to say when, if ever, this consent might be forthcoming, than it is to say when the petitioner might die or retire. But, if we indulge the assumption that the consent of petitioner to purchase from the donee was a reasonable probability, in view of the intrinsic value of the stock at the time of the gift, the price fixed by the contract for the purchase would not have been the book value as of December 31, 1939, but the book value as of December 31, 1940, or later, depending upon when petitioner's consent was forthcoming. And it may be noted that, if the death or retirement of the petitioner had occurred in the month following the gift, the purchase price fixed by the contract would also have been the book value as of December 31, 1940, which the Tax Court found to be approximately $400 a share; and, if petitioner's death had occurred in that month, this book value would have been greatly increased through the receipt by the corporation of the insurance upon petitioner's life.

We think it must be said that the contract relied on by petitioner tended to depress the fair market value of the stock at the time of the gift by limiting the class of prospective purchasers, by depriving holders of voting power and of the right to pledge the stock, and by subjecting them to the risks of the death or retirement of the holder from whom the stock was purchased, and to the chance of his consent to repurchase by the corporation at a value which conceivably might be less than the intrinsic value of the stock. *Worcester County Trust Co.* v. *Commissioner, supra,* at pages 581, 582 of 134 F.2d 578. But the Tax Court did not hold otherwise. On the contrary, it gave consideration to the contract and to its probable effect upon the fair market value of the stock for gift tax purposes when weighed against other relevant factors shown by the evidence. The Tax Court concluded its discussion of this feature of the case by saying:

> Under all the circumstances, we are not persuaded that any price at which the stock would change hands between petitioner as a willing seller and any willing buyer in a position to offer full value for the property would be so far below intrinsic value as to result in a figure less than the amount determined by respondent.

There are expressions in the opinion of the Tax Court which, lifted from their context, tend somewhat to support petitioner's argument, but a fair consideration of the court's opinion shows that in appraising the value of the stock it gave to the provisions of the restrictive contract the weight to which it thought them entitled in the light of all the evidence in the record. We can not say there is no warrant in the record for the Tax Court's conclusion. *Commissioner* v. *McCann, supra.* The question of value is a question of fact on which the Tax Court's finding supported by evidence may not be disturbed by the courts. . . .

What has just been said applies to the argument that the Tax Court was required to accept the estimate of petitioner's expert witness as to the value of the stock. The

weight of this testimony was for the Tax Court. Where, as here, there was other evidence before the court upon which it might reasonably make its own determination of value, it committed no error in rejecting the expert's opinion. . . .

The decision of the Tax Court is affirmed.

Note

1. In a recent ruling, the Internal Revenue Service announced the following views on the effect of restrictive agreements (Rev. Rul. 54-77, 54-1 C.B. 187, 193-4):

> Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. . . . However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

Why is a corporate option to repurchase stock at a fixed price "not determinative of fair market value for gift tax purposes"? Why is the option price not controlling in computing the estate tax if the stockholder is free to dispose of the stock during life and the option becomes effective only on his death? *Estate of Matthews* v. *Commissioner*, 3 T.C. 525 (1944); see also *Estate of Trammell* v. *Commissioner*, 18 T.C. 662 (1952); Rev. Rul 157, 53-2 C.B. 255 Assuming that the option itself is not controlling under these circumstances, should a distinction be made in those cases where the option is exercised and the estate receives only the option price for the shares?

Note the reservation in the ruling as to agreements that constitute devices "to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." See *Hoffman* v. *Commissioner*, 2 T.C. 1160, 1176-80 (1943); *Commissioner* v. *Bensel*, 100 F.2d 639 (3d Cir. 1938); *May* v. *McGowan*, 194 F.2d 396 (2d Cir. 1952). Even if the agreement is intended as such a device, should it be given effect on the ground that the difference between the option price and the unrestricted value of the stock was, in effect, given *inter vivos* by the stockholder to the option holder? Could there be a gift tax on the execution of an agreement by which a father gave his son the right to purchase his shares for a stated price on his death if the son survives him? Would a failure to exercise a favorable stock purchase option constitute a taxable gift?

Two brothers, who owned substantially all the stock of a corporation, agreed with the corporation that on the death of either one, the corporation would purchase part of the decedent's shares at $100 per share, a price greater than market value at the time of the agreement. Ten years later, when the stock was worth $420 per share, one of the brothers died, and the stock in question was sold to the corporation at the agreed price. It was held that the New Jersey inheritance tax was to be computed on the higher value:

> The net result of the transaction under review is that the [corporation] has

> succeeded to the possession and enjoyment of stock by a transfer intended to and actually taking effect after the death of the owner for a price far below its actual worth. The transfer thus becomes an effectual substitute for a testamentary disposition, in that there was a succession after death without adequate consideration. If the excess value goes untaxed, the corporation will have succeeded to it without the burden ordinarily imposed upon the right to such succession. Certainly the bargain made ten years before could not defeat the statutory policy.

Schroeder v. *Zink*, 4 N.J. 1, 71 A.2d 321, 326 (1950). The case apparently did not rest on the fact that relatives of the decedent owned all, or substantially all, of the corporation's outstanding stock, nor was there any suggestion that the agreement was not made for full and adequate consideration (the brothers were 5 years apart in age and both were in good health when the agreement was made) or that it was intended as a substitute for a legacy. Is the reasoning of the case applicable to cases involving federal estate tax liability? See also *In re Cowles' Estate*, 36 Wash.2d 710, 219 Pac.2d 964.

See generally Molloy, "Restraints on Alienation and the Internal Revenue Code," 7 *Tax L. Rev.* 439 (1952); Pavenstedt, "The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation," 51 *Mich. L. Rev.* 1 (1952).

If the option is exercised within one year after death, and the executor values the estate as of the optional valuation date, would the option price be controlling? See §2032(a)(1).

2. What if the corporation or the other stockholders are required to purchase the stock of the decedent at a fixed price that turns out to be greater than the stock's fair market value at the time of death?

3. If part or all of the estate's stock is to be redeemed by the corporation itself, and if the surviving shareholders are themselves interested in the estate, it is possible that a redemption will be taxed as a dividend under §302 of the 1954 Code. But §303 provides a degree of protection against this threat, by allowing enough stock to meet the estate's death taxes and funeral and administration expenses to be redeemed free of any dividend tax, if the stock of a single corporation constitutes more than 35 per cent of the value of the gross estate or more than 50 per cent of the taxable estate. *Supra*, p. 506.

4. The taxpayer purchased a diamond ring and a pair of diamond ear clips for $200,000 plus federal excise tax of $40,000 and gave them to her daughter a few months later. Should the federal excise tax be taken into account in determining the value of the property in computing the gift tax? What weight should be given to the fact that a private owner could not sell such jewelry at the same price, or as easily, as a dealer? If the jewelry had been purchased in order to make the gift, should the gift tax be computed as though the donor had made a gift of cash to enable the donee to purchase the jewelry? What if the jewelry had been purchased for the donor's own use, but she changed her mind a few weeks later and gave it to her daughter? See *Publicker* v. *Commissioner*, 206 F.2d 250 (3d Cir. 1953), cert den. 346 U.S. 924 (1954); *Duke* v. *Commissioner*, 200 F.2d 82 (2d Cir. 1952), cert. den. 345 U.S. 906 (1953); Rev. Rul. 55-71, 55-1 C.B. —. Should there be any difference in the way such property is valued for estate tax purposes?

5. Certain marketable United States bonds may be applied at par in payment of federal estate taxes provided they were owned by the decedent at the time of his death. If the quoted price for such bonds is below par, what is their value "at the time of [the decedent's] death"? Rev. Rul. 156, 53-2 C.B. 253. Certain non-marketable United States bonds may be similarly applied at par, but if not so applied can either be held until maturity or redeemed at varying amounts below par. What is their estate tax value? *Collins* v. *Commissioner*, 216 F.2d 519 (1st Cir. 1954).

See generally Gordon, "What Is Fair Market Value?" 8 *Tax L. Rev.* 35 (1952).

CHAPTER 15

THE EXEMPTION, DEDUCTIONS, AND CREDITS

Section A. The $60,000 Exemption: Section 2052

The "gross estate" comprises all of the property described in §§2031-43, which were examined in Chapters 2-5 of this Part. The "taxable estate," to which the tax rates set out in § 2001 are applied, is defined by § 2051 as the "gross estate" less the $60,000 exemption of § 2052 and the deductions of §§2053-56. One other definition is important: the "marital deduction" of §2056 may not exceed 50 per cent of the value of the "adjusted gross estate," a term defined by §2056(c)(2)(A) as the "gross estate" less the deductions permitted by §§ 2053 and 2054.*

An estate tax return must be filed whenever the gross estate of a citizen or resident alien exceeds $60,000, even though no tax is due because of the allowable deductions. Section 6018(a)(1). During the calendar year 1951, about 28,000 estate tax returns were filed, of which about one-third showed no tax due. Treasury Department, *Statistics of Income for 1950*, p.234 (1954). In the same year, according to the *World Almanac*, there were 1,452,454 deaths in the United States Although these figures are not entirely parallel, because the estate tax return is not due until 15 months after death, they do demonstrate that only a small fraction of the population is sufficiently affluent to be concerned about the federal estate tax. The taxable returns reported aggregate gross estates of about $4.7 billion, aggregate exemptions of about $1.1 billion, and tax liability of about $0.6 billion. The non-taxable returns reported aggregate gross estates of about $0.8 billion and aggregate exemptions of about $0.5 billion.

Before 1954, the estate tax structure consisted of a basic and an additional estate tax. An exemption of $100,000 was allowed in computing the basic tax, but the exemption for the additional estate tax was $60,000. The only function of the separate computations was to serve as a ceiling on the credit for state death taxes, which was limited, for historical reasons set out *infra*, pp. 1225–30, to 80 per cent of the federal basic tax The computation of the estate tax was simplified in 1954 by combining the two taxes in §2001, without any change in the total tax due (except for some non-resident aliens). Because some state laws refer to the federal basic estate tax, however, §2011(d) provides a method of computing it.

Section B. Expenses, Indebtedness, Taxes: Section 2053

Before 1954, the total allowance for the items set out in what is now §2053(a)

* For estates containing community property, see §2056(c)(2)(B).

could not exceed that part of the taxable property that could be reached by the decedent's creditors. This limitation was enacted in 1942, to overrule judicial decisions that the full amount of claims against the decedent's estate was deductible, even though they exceeded the value of the property subject to their payment. Thus, claims against an insolvent estate could have been deducted from the proceeds of life insurance policies or other property which, though part of the "gross estate," were exempt from general claims under local law. *Commissioner* v. *Windrow,* 89 F.2d 69 (5th Cir. 1937); *Hays* v. *Commissioner,* 34 B.T.A. 808 (1936). In order to stop this "tax free transfer of assets to the decedent's beneficiaries," the 1942 amendment disallowed deductions to the extent that they "exceed the value, at the time of decedent's death, of property subject to claims." H. Rep. 2333, 77th Cong., 2d Sess., 163-4, Sen. Rep. No. 1631, 77th Cong., 2d Sess., 236-7. See *Estate of Lande* v. *Commissioner,* 21 T.C. 977 (1954).

The 1954 statute, by §2053(c)(2), lifts this restriction to the extent that the amounts are paid before the estate tax return is due Thus, even though the entire gross estate is composed of property not subject to claims under local law (such as property held in tenancy by the entirety), funeral expenses, debts, *etc.*, actually paid before the estate tax return is due may be deducted. Note that §2053(a) permits expenses, debts, *etc.*, to be deducted only if "allowable" under local law. Are such items "allowable" if they exceed in value the property subject to claims? The Senate Report, p.124, states that this restriction means that the items must be "of the type which would be allowed as deductions if the property were in the probate estate."

1. *Funeral Expenses*

Note

It has been held that an amount set aside by the decedent's will for perpetual maintenance of a family mausoleum in which she was interred, is deductible under §2053 (a)(1) if it is allowable as a funeral expense under state law. *Estate of Cardeza* v. *Commissioner,* 5 T.C. 202, 220-1 (1945), aff'd. 173 F.2d 19 (3 Cir. 1949); see *Igleheart* v. *Commissioner,* 77 F.2d 704, 712-3 (5th Cir. 1935), disallowing a deduction where it was not shown that the amount was allowable under state law. If the decedent makes a bequest for acquisition or maintenance of a family cemetery plot in an amount exceeding what would be allowable under state law in the absence of a bequest, can the excess be treated as an "expense" under §2053(a)(1)?

2. *Administration Expenses*

REGS. 105, SEC. 81.32

The amounts deductible from the gross estate as "administration expenses" are such expenses as are actually and necessarily incurred in the administration of the estate; that is, in the collection of assets, payment of debts, and distribution among the persons entitled. The expenses contemplated in the law are such only as attend the settlement of an estate by the legal representative preliminary to the transfer of the property to individual beneficiaries or to a trustee, where such trustee is the executor or some other person. Expenditures not essential to the proper settle-

ment of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in sections 81.33 to 81.35, inclusive.

Note

1. At the time the return is filed, the amount of the executor's commissions will often be as yet undetermined. Sec. 81.33 of Regs. 105 provides:

> In case the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the final audit of the return provided. (1) That the Commissioner is reasonably satisfied that the commissions claimed will be paid; (2) that the amount entered as a deduction is within the amount allowable by the laws of the jurisdiction wherein the estate is being administered; and (3) that it is in accordance with the usually accepted practice in such jurisdiction to allow such an amount in estates of similar size and character.

A similar procedure is allowed for the deduction of attorneys' fees. Sec. 81.34.

Suppose that suit is brought to expunge a deficiency in, or to secure a refund of, federal estate tax. Thereafter the estate pays its attorney for his services, claims a deduction for the payment, and sues for a refund. Is the judgment in the first action a bar to the second? *Magruder* v. *Safe Deposit and Trust Co.,* 159 F2d 913 (4th Cir. 1947); *Cleveland* v. *Higgins,* 148 F.2d 722 (2d Cir. 1945), cert. den., 326 U.S. 722; *cf. Moir* v. *United States,* 149 F.2d 455 (1st Cir. 1945); 59 *Harv. L. Rev.* 1322 (1946). The second paragraph of Sec. 81.34, Regs. 105 was added to the regulations on December 22, 1947 "to clarify the regulations as to the time for claiming a deduction for attorneys' fees incurred in contesting an asserted deficiency or in prosecuting a claim for refund." See *First National Bank of Atlanta* v. *Allen,* 100 F. Supp. 133 (M D.Ga. 1951).

2. Some administration expenses may also be "ordinary and necessary expenses" incurred in carrying on a trade or business or in producing or collecting income (§§162 and 212, 1954 Code), thus qualifying as deductions in computing the estate's *income* tax liability. The executor may not deduct such expenses in the income tax return unless he waives the right to deduct them in the estate tax return. Section 642(g). Before 1942, when this subsection was enacted, the possibility existed of deducting some expenses both on the estate tax return as administration expenses and on the estate's income tax return as ordinary and necessary business expenses. See *Adams* v. *Commissioner,* 110 F.2d 578 (8th Cir. 1940). Were it not for §642(g), this possibility would have been greatly enlarged after 1942 because of the enactment in that year of §212. For that section rejected *Higgins* v. *Commissioner,* 312 U.S. 212 (1941), and for the first time authorized the deduction of expenses incurred in producing income or in managing property held for the production of income. *Supra,* p. 196.

3. Sec. 81.33, Regs. 105, provides: "Amounts paid as trustees' commissions do not constitute expenses of administration and are not deductible, whether received by the executor acting in the capacity of a trustee or by a separate trustee as such." In *Estate of Sharpe* v. *Commissioner,* 148 F.2d 179 (3d Cir. 1945), the court said:

> We think the distinction maintained in the Regulation between executors' commissions and trustees' commissions is a sound one. The work of the executor is part of the settlement of a decedent's estate. It is done for the benefit of all who are interested, his creditors, his next of kin, his legatees. But the carrying on of the trust is a different enterprise, not in settlement of a dead man's affairs, but for the benefit of the beneficiaries of the trust. It operates to continue the affairs of the living, not to close up those of the departed. *Central Hanover Bank & Trust Co.* v. *Commissioner of Internal Revenue,* 2 Cir., 1941, 118 F.2d 270 is directly in point and we think it is correct. That decision points out the fact that the amount

of such commissions over future years is conjectural. This is another and valid reason for not deducting them in addition to the one already noted.

Section 2053(b), new in the 1954 Code, allows such items as the expenses of administering a trust that is part of the gross estate to be deducted therefrom even though the trust is not subject to claims. Often it will not matter whether such expenses are deducted from the value of the trust in determining the value of the gross estate or are instead deducted as expenses from the gross estate after the value of the trust (undiminished by such expenses) has been included in the gross estate. But in computing the marital deduction, the method of allowing for such expenses may be relevant. See Rev. Rul. 293, 53-2 C.B. 257.

3. *Claims, Mortgages, and Indebtedness*

COMMISSIONER v. WRAGG

U.S. Court of Appeals, First Circuit, 1944
141 F.2d 638

Before MAHONEY and WOODBURY, Circuit Judges, and PETERS, District Judge.

WOODBURY, Circuit Judge.

This is a petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States holding that there is no deficiency in the federal estate tax paid by the respondent on the Estate of one George H. Lowe, Sr. The statute involved is §303 of the Revenue Act of 1926, as amended [§2053(a)(3), 1954 Code].

The Tax Court found the following facts. Between 1883 and 1910 the decedent devoted his time exclusively to the business of Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Co., both successful corporations, and during that time the decedent acquired substantial amounts of stock in both of them. This stock was closely held, unlisted and without a ready market.

About 1910 the decedent and his son, George H. Lowe, Jr., organized the Weymouth Art Leather Company, a corporation which engaged in the business of manufacturing a leather substitute by painting cloth. The decedent furnished the original capital for this corporation and served as an officer and a director of it until 1932. He placed his son in charge of its affairs.

During the period from 1917 or 1918 to 1925 the decedent pledged all of his shares of stock in Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Co. as collateral to secure various promissory notes for money borrowed from individuals and banking institutions by George H. Lowe, Jr. Some of these notes the decedent also either signed as co-maker or endorsed. A substantial part of the money borrowed by the son and for which the decedent pledged his stocks was used to finance Weymouth. Weymouth was solvent when the loans were negotiated and both the decedent and his son expected that the loans would be repaid.

By 1932 the decedent's health had begun to fail and the various holders of the notes and obligations which had been created by George H. Lowe, Jr. and the decedent were pressing for payment and threatening to sell the shares owned and deposited by the decedent as collateral. In this state of affairs on February 25,

1932, Samuel H. Wragg, the respondent, was appointed conservator of the decedent's estate by the Norfolk County Probate Court. Immediately upon his appointment the conservator brought a petition in the above Probate Court seeking to restrain the various persons and institutions holding collateral notes from selling the collateral, and, after hearing on the merits, that court enjoined all parties holding such securities from selling them. When the conservator took office the total obligations for which the decedent had pledged his shares in Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Company amounted to approximately $233,000 and the pledged shares had a book value of about double that amount.

For a number of years prior to 1932 the decedent had also given direct financial assistance to his son, some of which the son had from time to time repaid. In 1934, the conservator brought an action in the Municipal Court of the City of Boston against the son for the money advanced directly to him and recovered a judgment therein in the amount of two hundred and forty-five thousand dollars. Execution issued on November 3, 1934, but it does not appear that it was ever levied upon or that anything was ever paid in satisfaction thereof.

During the course of his duties as conservator the respondent refinanced certain of the loans secured by pledge of the decedent's stocks in order to save the equity in those stocks for the estate, it being necessary for him to secure title to the pledged stocks in order to sell them in one block.

George H. Lowe, Sr., died, testate, a resident of Needham, Massachusetts, on February 11, 1937, and his former conservator was appointed and duly qualified as administrator c.t.a.d.b.n. of his estate. In his estate tax return he deducted the amounts due at the date of death, that being the date selected for valuing the estate, on the notes endorsed by his decedent or signed by him as co-maker, or secured by collateral owned by him, and he also deducted the amounts due on notes signed by himself as conservator, the proceeds of which had been used to discharge similar notes. The question is whether these deductions are authorized.

The Commissioner does not question the sufficiency of the evidence to support the Tax Court's finding that "There can be no question as to the bona fides of the several transactions here questioned. Nor is there any doubt as to the obligations being contracted for adequate and full consideration in money or money's worth. All were normal business deals." Neither does he again urge, as he has so many times in the past, always in vain, that the deductions taken cannot be allowed because the consideration for the claims against the estate did not flow to the decedent. . . . His position here, to quote from his brief, is that "The claim and the indebtedness in respect to the property of the decedent were on account of obligations in respect to which the son was primarily liable. The estate, therefore, had a right to indemnity or of contribution against the son. In allowing the deductions here in controversy, the Tax Court erred in ignoring this right of indemnity or contribution from the son. The record does not show nor did the Tax Court find that the son was insolvent or unable to reimburse the estate for the sums paid in satisfaction of the son's indebtedness." That is to say, the Commissioner contends that a bona fide business obligation of a secondary nature undertaken for money or money's worth cannot be deducted for estate tax purposes unless the value of the decedent's right over against the primary obligor is included in computing the gross estate, and since there was no evidence presented

to, or finding made by, the Tax Court that the decedent's right over against his son was valueless, the deduction ought not to be allowed because the person claiming a deduction has the burden of proving that he is entitled to it.

The statute makes no specific mention of rights of reimbursement, contribution or indemnity, but it does provide for inclusion in the gross estates of decedents of the value at the time of death of "all property, real or personal, tangible or intangible, wherever situated" [§2031(a), 1954 Code], and these words are clearly broad enough to include such rights. The courts in the cases to be cited hereafter have, at least tacitly, so construed them. The crucial question in cases of this sort is what such a right is worth. If it is worth one hundred cents on the dollar, an estate will not be reduced by a secondary obligation of the decedent, but if it is worth nothing, a secondary obligation will be as effective as a primary one to reduce the net value of an estate. It is upon this truism that the courts and the Board of Tax Appeals appear, if inarticulately, to have proceeded in the past.

Thus when it has appeared that the decedent's right over against the primary obligor was worth its face value, no deduction has been allowed for a secondary liability (*Estate of Lay*, 40 B.T.A. 522; *Hartford Nat. Bank & Trust Co.* v. *Smith*, D.C. Conn., 54 F.Supp. 579; see also *Parrott* v. *Commissioner*, 9 Cir., 30 F.2d 792, certiorari denied 279 U.S. 870, *Buck* v. *Helvering*, 9 Cir., 73 F.2d 760); but when it has appeared that the right over was valueless a deduction for it has been allowed. *United States* v. *Mitchell*, 7 Cir., 74 F.2d 571, *Commissioner* v. *Porter*, 92 F.2d 426; *Carney* v. *Benz*, 1 Cir., 90 F.2d 747; *Dodge* v. *Gagne*, D.C., 23 F.Supp. 729. And, when it has appeared that the right was worth something but not its face value a deduction has been allowed to the extent of the amount which actually had to be paid and could not be recovered from the primary obligor by the estate. *McCoy* v. *Rasquin*, 2 Cir., 102 F.2d 434; *Eckhart* v. *Commissioner*, 33 B.T.A. 426, 440, *Estate of Borland*, 38 B.T.A. 598. In view of these cases, particularly the two last cited, it does not seem to us that the Tax Court in the case at bar would have allowed the deduction unless it had come to the conclusion that the right of the estate over against the primary obligor, the decedent's son, was valueless. To be sure it made no such finding categorically, but nevertheless we feel that such a finding is implicit in the factual background of the case and that it must have been assumed by the Tax Court that the estate would ultimately have to bear the loss or else it would not have reached the result which it did. The facts upon which we base our conclusion are that at various times the creditors had threatened to sell the collateral pledged to secure the notes, that upon some occasions actions were instituted by creditors against the decedent's estate on the notes, and that the execution on the judgment obtained by the conservator against the son was never levied upon or satisfied although the conservator as a fiduciary was under a legal duty to collect on his judgment, regardless of the family relationship involved, if he could. It seems to us that the creditors would not have taken the steps which they did if the son had been solvent, and that the conservator, if possible, would have collected on his judgment against the son. In the absence of evidence we cannot assume that he neglected to do so in breach of his fiduciary duties. Thus we think that the Tax Court must have concluded, but merely failed to state, that the right of the estate over against the son was valueless, and, this being so, we see no point in remanding the case for a definite finding to that effect.

The decision of the Tax Court of the United States is affirmed.

Note

1. Did the decedent's "rights of reimbursement, contribution or indemnity" exist "at the time of his death," as required by §2031, or would they arise only when the creditors were paid? See *Estate of Du Val* v. *Commissioner*, 152 F.2d 103 (9th Cir. 1945), cert. den., 328 U.S. 838 (1946).

2. As to whether the consideration required to support a contractual claim must "flow" to the decedent, compare the statement of the Supreme Court in *Commissioner* v. *Wemyss*, *supra*, p. 921. "If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct." In *Latty* v. *Commissioner*, 62 F.2d 952, 954 (6th Cir. 1933), construing the words "consideration in money or money's worth," the court said "We think that ordinarily these words must be construed to evidence an intent upon the part of Congress to permit the deduction of claims only to the extent that such claims were contracted for a consideration which at the time either augmented the estate of the decedent, granted to him some right or privilege he did not possess before, or operated to discharge a then existing claim, as for breach of contract or personal injury."

3. Section 2053(a) items may be deducted only if they "are allowable by the laws of the jurisdiction . . . under which the estate is being administered." Consider the possibility that a doubtful claim or one barred by the statute of limitations may be allowed by the executor and the probate court, because it is held by the residuary legatee who will receive the balance of the estate in any event or by a member of the family whom the other legatees wish to benefit. For the effect of a probate court decree on deductibility, see Regs. 105, Sec. 81.30; *Estate of Goodwin* v. *Commissioner*, 201 F.2d 576 (6th Cir. 1953), see also references cited *supra*, pp. 972–3.

4. The Revenue Act of 1932 struck out earlier language restricting the deduction "to the extent that such claims, mortgages, or indebtedness were incurred or contracted bona fide and for an adequate and full consideration in money or money's worth" and substituted the present language of §2053(c)(1)(A). The House Committee on Ways and Means explained (H. Rep. No. 708, 72d Cong., 1st Sess., 1939–1 C.B. (Part 2), p. 491): "The existing law might be open to a construction under which no claim against the estate would be deductible unless supported by an 'adequate and full consideration in money or money's worth,' but the real intent could hardly have been to deny the deduction of liabilities imposed by law or arising out of torts, and the amendment whereby the requirement of a consideration applied only where the liability is founded on contract is designed to clear up any doubt which may be thought to exist."

5. The specific allowance in §2053(c)(1)(A) for charitable subscriptions is a legislative overruling (Revenue Act of 1942) of *Taft* v. *Commissioner*, 304 U.S. 351 (1938), holding that an individual subscription, though enforceable, was not contracted for adequate and full consideration in money or money's worth. The *Taft* case left in doubt the status of pledges in consideration of the pledges of others.

6. For the extent to which the phrase "founded on a promise or agreement" in §2053(c)(1)(A) is applicable to a marital settlement, see *supra*, p. 934. Note also that by virtue of §2043(b), marital rights do not constitute "adequate and full consideration in money or money's worth" for purposes of §2053(c)(1)(A), but that the Internal Revenue Service has ruled that the right to support is not a "marital right" under §2043(b), *supra*, p. 934.

4. Support of Dependents

Note

The Revenue Act of 1950 repealed §812(b)(5) of the 1939 Code, which had permitted the estate to deduct amounts "reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent"

to the extent allowed by the laws of the jurisdiction of administration. The Senate Finance Committee explained its recommendation for repeal as follows (S. Rept. No. 2375, 81st Cong., 2d Sess., p. 57):

> This deduction is inconsistent with the concept of the estate tax as a tax on all properties transferred at death. In practice it has discriminated in favor of estates located in States which authorize liberal allowances for the support of dependents, and it has probably also tended to delay the settlement of estates.

For questions that arose under the repealed provision, see *Estate of Jacobs* v. *Commissioner*, 8 T.C. 1015 (1947), and *Estate of Brudermann* v. *Commissioner*, 10 T.C. 560 (1948).

Section C. Casualty Losses: Section 2054

Section 2054 allows the deduction of losses incurred during the settlement of estates "arising from fires, storm, shipwrecks, or other casualties, or from theft," if not compensated for by insurance or otherwise. The specified causes are identical with those in §165(c)(3), *supra*, pp.180-8. A loss that is claimed in computing the estate tax, however, may not be deducted a second time in computing the estate's income tax. Sections 165(c)(3) and 642(g).

Section 165(c)(3) is explicitly restricted to losses of *property*. Is §2054 similarly restricted, or could a loss of potential profits, brought on by shipwreck or fire, be deducted from the value of the gross estate? The deduction under §165 (c)(3) may not exceed the "basis" of the lost property, by virtue of §165(b); see also *Helvering* v. *Owens*, *supra*, p.184. In the case of a loss under §2054, may the full value of property at the time of the loss be deducted, even if by reason of inflation it exceeds the estate tax value? If property declines in value after the date of death, how is the loss to be computed?

In *Leewitz* v. *United States*, 75 F.Supp. 312 (Ct.Cl. 1948), cert. den. 335 U.S. 820 (1948), the court made this comment on §2054:

> At the outset it should be observed that we are here concerned with losses for estate tax purposes where the only losses allowable are those above mentioned, as contrasted with losses allowable for income tax purposes, which include business losses, such as from bad debts, and losses on transactions entered into for profit as well as losses of the kind allowed for estate tax purposes. Only one estate tax return is filed and therefore, once a deduction is allowed, there is no chance for adjustment in another estate tax return in the event there should be some recovery on account of the item for which the deduction was allowed. On the other hand, income tax returns are filed on an annual basis and any recoveries with respect to a deduction allowed in one year will be reflected in income adjustments in a subsequent year. This comparison becomes significant as indicating the nature of the losses which are allowable for estate tax purposes; namely, losses from which no recovery would ordinarily be expected, such as from fires or storms. In addition, these losses have reference to destruction of or damage to physical property where the extent of the loss can be fully measured as of the time the loss is allowed without the necessity for future readjustment. (75 F.Supp. at 317.)

Assuming that a loss did result from casualty, within the meaning of §2054, must the *amount* of the loss be proved with greater accuracy than is required under §165(c)(3)?

A similar problem arises with respect to proof that the loss is not compensated

for by insurance or otherwise. The extent of compensation is often undetermined in the year the casualty occurs; in the income tax field, it is only a matter of timing whether the taxpayer holds the item in abeyance until his claim for compensation is settled or deducts the full amount of the loss in the earlier year and reports the insurance or other recovery as income in the year of settlement. *Supra*, p.188. If the amount of a loss was uncertain when the estate tax return was filed, can it be claimed on an amended return when finally liquidated? Must a loss, to be deducted under §2054, occur before the estate tax return is due?

Section D. Charitable Bequests: Section 2055

During the calendar year 1951, about 28,000 federal estate tax returns were filed for estates of citizens and resident aliens, reporting about $275 million of charitable bequests from gross estates aggregating about $5,500 million. In 1950, about 39,000 gift tax returns were filed, reporting about $140 million of charitable gifts out of aggregate total gifts of about $820 million.

See *supra*, pp 165-9 and 629-640, for references to the many recent discussions of the issues of policy that are presented by the tax incentives to charitable contributions. See also Harriss, "Federal Estate Taxes and Philanthropic Bequests," 57 *J. Pol. Econ.* 337 (1949).

MERCHANTS NATIONAL BANK v. COMMISSIONER

Supreme Court of the U.S., 1943
320 U.S. 256

MR. JUSTICE RUTLEDGE delivered the opinion of the Court.

Ozro M. Field died in Massachusetts in 1936, leaving a gross estate of some $366,000. In his will he provided, after certain minor bequests, that the residue of his estate be held in trust, the income to go to his wife for life, and on her death all but $100,000 of the principal[1] to go "free and discharged of this trust" to certain named charities. Under the trust set up by the will, the trustee, petitioner here, was authorized to invade the corpus "at such time or times as my said Trustee shall in its sole discretion deem wise and proper for the comfort, support, maintenance, and/or happiness of my said wife, and it is my wish and will that in the exercise of its discretion with reference to such payments from the principal of the trust fund to my said wife, May L. Field, my said Trustee shall exercise its discretion with liberality to my said wife, and consider her welfare, comfort and happiness prior to claims of residuary beneficiaries under this trust."

[Under what is now §2055, the executor deducted as charitable bequests the value of the remainder interest in the trust, without making any allowance for the trustee's power to invade the principal for the benefit of the widow. The

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[1] The $100,000 was to remain in trust, the income to go in equal shares to his three adopted children and a niece of his wife, and on the death of the last of these beneficiaries the corpus was also to go to the named charities.

deduction was disallowed by the Commissioner, the executor filed a petition in the Tax Court and won, the Court of Appeals for the First Circuit reversed, and the Supreme Court granted certiorari.]

There is no question that the remaindermen here were charities. The case, at least under §303(a)(3) [§2055,1954 Code], turns on whether the bequests to the charities have, as of the testator's death, a "presently ascertainable" value or, put another way, on whether, as of that time, the extent to which the widow would divert the corpus from the charities could be measured accurately.

Although Congress, in permitting estate tax deductions for charitable bequests, used the language of outright transfer, it apparently envisaged deductions in some circumstances where contingencies, not resolved at the testator's death, create the possibility that only a calculable portion of the bequest may reach ultimately its charitable destination.[2] The Treasury has long accommodated the administration of the section to the narrow leeway thus allowed to charitable donors who wish to combine some private benefaction with their charitable gifts. The limit of permissible contingencies has been blocked out in a more convenient administrative form in Treasury Regulations which provide that, where a trust is created for both charitable and private purposes the charitable bequest, to be deductible, must have, at the testator's death, a value "presently ascertainable, and hence severable from the interest in favor of the private use," [3] and further, to the extent that there is a power in a private donee or trustee to divert the property from the charity, "deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power." [4] These Regulations are appropriate implementations of §303(a)(3), and, having been in effect under successive reenactments of that provision, define the framework of the inquiry in cases of this sort. *Cf. Helvering* v. *Winmill*, 305 U.S. 79; *Taft* v. *Commissioner*, 304 U.S. 351.

Whatever may be said with respect to computing the present value of the bequest of the testator who dilutes his charity only to the extent of first affording specific private legatees the usufruct of his property for a fixed period, a different problem is presented by the testator who, preferring to *insure* the comfort and happiness of his private legatees, hedges his philanthropy, and permits invasion of the corpus for their benefit. At the very least a possibility that part of the principal will be used is then created, and the present value of the remainder which the charity will receive becomes less readily ascertainable. Not infrequently the standards by which the extent of permissible diversion of corpus is to be measured embrace factors which cannot be accounted for accurately by reliable statistical data and techniques. Since, therefore, neither the amount which the private beneficiary will use nor the present value of the gift can be computed, deduction is not permitted. *Cf. Humes* v. *United States*, 276 U S 487.

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[2] *E.g.*, the not unusual case of a bequest of income for life intervening between the testator and the charity, requiring computation, with the aid of reliable actuarial techniques and data, of present value from future worth Compare the provisions for charitable deductions in the Revenue Acts of 1918—§403(a)(3) (40 Stat. 1098; 1921—§403(a)(3) (42 Stat 279); 1924 —§303(a)(3) (43 Stat. 306); 1926—§303(a)(3) (44 Stat. 72).

[3] Regs. 105, Sec. 81.44(a).

[4] Regs. 105, Sec. 81.46.

For a deduction under §303(a)(3) to be allowed, Congress and the Treasury require that a highly reliable appraisal of the amount the charity will receive be available, and made, at the death of the testator. Rough guesses, approximations, or even the relatively accurate valuations on which the market place might be willing to act are not sufficient. *Cf. Humes* v. *United States*, 276 U.S. 487, 494. Only where the conditions on which the extent of invasion of the corpus depends are fixed by reference to some readily ascertainable and reliably predictable facts do the amount which will be diverted from the charity and the present value of the bequest become adequately measurable. And, in these cases, the taxpayer has the burden of establishing that the amounts which will either be spent by the private beneficiary or reach the charity are thus accurately calculable. *Cf. Bank of America Assn.* v. *Commissioner*, 126 F.2d 48 (C.C.A.).

In this case the taxpayer could not sustain that burden. Decedent's will permitted invasion of the corpus of the trust for "the comfort, support, maintenance and/or happiness of my wife." It enjoined the trustee to be liberal in the matter, and to consider her "welfare, comfort and happiness prior to the claims of residuary beneficiaries," *i.e.*, the charities.

Under this will the extent to which the principal might be used was not restricted by a fixed standard based on the widow's prior way of life. Compare *Ithaca Trust Co.* v. *United States*, 279 U.S. 151.* Here, for example, her "happiness" was among the factors to be considered by the trustee. The sums which her happiness might require to be expended are of course affected by the fact that the trust income was not insubstantial and that she was sixty-seven years old with substantial independent means and no dependent children.[5] And the laws of Massachusetts may restrict the exercise of the trustee's discretion some-

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* In the *Ithaca Trust Co.* case, the value of the remainder interest in a trust was allowed as a charitable bequest, although the decedent's widow had (in addition to a life interest in the income) the right to use principal to such extent as "may be necessary to suitably maintain her in as much comfort as she now enjoys." The court said "The standard was fixed in fact and capable of being stated in definite terms of money. It was not left to the widow's discretion. The income of the estate at the death of the testator, and even after debts and specific legacies had been paid, was more than sufficient to maintain the widow as required. There was no uncertainty appreciably greater than the general uncertainty that attends human affairs." The court also held that in valuing the charitable bequest, allowance had to be made for the life interest of the widow computed on an actuarial basis as of the date of the decedent's death, although she had died before the estate tax return was due. [Ed.]

[5] The Board of Tax Appeals found that decedent had adopted three children—two girls and a boy—before his marriage to the present Mrs. Field. She never adopted the children. The two girls were married to husbands fully able to support them, and the boy was nearly twenty-one at the testator's death.

Immediately after decedent's death the widow owned income-producing property worth about $104,000. Her total income from her own property and the trust, and the amounts she has actually expended have been as follows·

Period	*Income*	*Expenditures*
1936 (7 months)	$10,735.35	$1,853.99
1937	24,738.57	10,357.91
1938	17,480.85	11,055.91
1939	17,448.23	12,024.92
1940	16,959.66	13,389.31
	$87,362.66	$48,682.04

what more narrowly than a liberal reading of the will would suggest, although that is doubtful. *Cf. Dana* v. *Dana,* 185 Mass. 156, 70 N.E. 49, and compare *Sparhawk* v. *Goldthwaite,* 225 Mass. 414, 114 N.E. 718. Indeed one might well "guess, or gamble . . . , or even insure against" the principal being expended here. *Cf. Humes* v. *United States, supra.* But Congress has required a more reliable measure of possible expenditures and present value than is now available for computing what the charity will receive. The salient fact is that the purposes for which the widow could, and might wish to have the funds spent do not lend themselves to reliable prediction.[6] This is not a "standard fixed in fact and capable of being stated in definite terms of money." *Cf. Ithaca Trust Co.* v. *United States, supra.* Introducing the element of the widow's happiness and instructing the trustee to exercise its discretion with liberality to make her wishes prior to the claims of residuary beneficiaries brought into the calculation elements of speculation too large to be overcome, notwithstanding the widow's previous mode of life was modest and her own resources substantial. We conclude that the commissioner properly disallowed the deduction for estate tax purposes. . . .

Accordingly, the decision of the Court of Appeals is affirmed.

Mr. Justice Douglas, with whom Mr. Justice Jackson concurs, dissenting:

The Tax Court applied the correct rule of law in determining whether the gifts to charity were so uncertain as to disallow their deduction. That rule is that the deduction may be made if on the facts presented the amount of the charitable gifts are affected by "no uncertainty appreciably greater than the general uncertainty that attends human affairs." *Ithaca Trust Co.* v. *United States,* 279 U.S. 151, 154. In that event the standard fixed by the will is "capable of being stated in definite terms of money." *Id.,* p. 154. The mere possibility of invasion of the corpus is not enough to defeat the deduction. The Tax Court applied that test to these facts. 45 B.T.A. 270, 273–274. Where its findings are supported by substantial evidence they are conclusive. We may modify or reverse such a decision only if it is "not in accordance with law." [§7482(c)(1), 1954 Code.] See *Wilmington Trust Co.* v. *Helvering,* 316 U.S. 164, 168. The discretion to pay to the wife such principal amounts as the trustee deems proper for her "happiness" introduces of course an element of uncertainty beyond that which existed in the *Ithaca Trust Co.* case. There the trustee only had authority to withdraw from the principal and pay to the wife a sum "necessary to suitably maintain her in as much comfort as she now enjoys." But the frugality and conservatism of this New England corporate trustee, the habits and temperament of this sixty-seven year old lady, her scale of living, the nature of the investments—these facts might well make certain what on the face of the will might appear quite uncertain. We should let that factual determination of the Tax Court stand, even though we would decide differently were we the triers of fact.

Note

1. Several years later, this issue was before the Supreme Court again. In *Henslee*

[6] *E.g.,* the Board found that since her husband's death, Mrs. Field purchased two automobiles and a fur coat, took two pleasure trips, gave financial assistance to a niece, helped send a grand nephew through medical school, and purchased a fur coat for one of her husband's daughters.

v. *Union Planters Nat. Bank & Trust Co.*, 335 U.S. 595 (1949), a deduction was denied under these circumstances the decedent's will provided that his gross estate of about $500,000 was to be held in trust for his mother, aged 85, to pay her $9,000 per year for life, with the remainder (after certain legacies) to go to charities. The trustees could also pay the decedent's mother any part of the estate for her "pleasure, comfort and welfare." The estate was earning a net income of about $15,000 at the time of the decedent's death, and his mother, a women "of moderate needs and without dependents," had investments of her own worth about $100,000. The Court held:

> We do not overlook the unlikelihood that a woman of the mother's age and circumstances would abandon her customary frugality and squander her son's wealth. But, though there may have been little chance of that extravagance which would waste a part or consume the whole of the charitable interest, that chance remained What common experience might regard as remote in the generality of cases may nonetheless be beyond the realm of precise prediction in the single instance The contingency which would have diminished or destroyed the charitable interest here considered might well have been insured against, but such an arithmetic generalization of experience would not have made this charitable interest "presently ascertainable."

Justices Douglas and Jackson dissented on the grounds stated in their dissent in the *Merchants Nat. Bank* case Justice Frankfurter wrote:

> Wisdom too often never comes, and so one ought not to reject it merely because it comes late. Since I now realize that I should have joined the dissenters in the *Merchants Nat. Bank* case, 320 U.S. 256, I shall not compound error by pushing that decision still farther. I would affirm the judgment, substantially for the reasons given below. 166 F.2d 993.

The lower courts have had a hard time finding their way between the *Ithaca Trust Co.* case and the *Merchants Nat. Bank* case. See, for example, *Lincoln Rochester Trust Co.* v. *McGowan*, 217 F.2d 287 (2d Cir. 1954), and *Blodget* v. *Delaney*, 201 F.2d 589 (1st Cir. 1953). In the *Lincoln Rochester Trust Co.* case, the district court had submitted to a jury the question whether "it can be predicted with reasonable accuracy" whether the trustee of a trust would make distributions to a life tenant. P-H Fed. Tax Serv. ¶ 132,619 (W.D N.Y. 1953). In the *Blodget* case, Judge Magruder (concurring) wrote:

> If there is a "clear Congressional policy not to benefit the national revenue at the expense of charitable institutions," it seems that the decided cases have drawn an unfortunate line in denying a charitable deduction wherever the power to invade corpus is conferred in terms embracing "factors which cannot be accounted for accurately by reliable statistical data and techniques," 320 U.S. at page 261, even though on the existing facts and circumstances one might conclude to a moral certainty that the power would never be exercised and that the unimpaired remainder would go to the charity upon the death of the life tenant. . . Instead of having to split hairs between "comfort and welfare" on the one hand and "comfort, support, maintenance, and/or happiness" on the other, it might seem more logical to adopt either of two alternatives. (1) To deny the charitable deduction unless the testator has given an indefeasible remainder to charity upon the death of the life tenant, or (2) to allow the deduction in full wherever it is properly found as a fact upon consideration of all the circumstances that the chance of invasion of the corpus is negligible, however broadly or narrowly the power to invade corpus may be expressed in the will. (201 F.2d at 594-5.)

Note the position taken by the Internal Revenue Service in Rev. Rul. 54-538, *supra*, p. 1153.

Is the United States bound by the holding of a state court that a life tenant has no power to invade corpus? *Hendricksen* v. *Baker-Boyer Nat. Bank*, 139 F.2d 877 (9th Cir. 1944); *supra*, p. 1208.

2. Note the parenthetical clause in the first sentence of §2055(a). If the widow in the *Merchants Nat. Bank* case had relinquished her right to receive distributions of corpus, apparently the Tax Court would hold that the value of the remainder could be deducted as a charitable bequest, even if the trust was a spendthrift trust *Estate of Schoonmaker* v. *Commissioner,* 6 T.C. 404 (1946). See also the last sentence of §2055(a), which was added in 1954; 100 *Cong. Rec.* 9496–7 (1954).

3. In *Commissioner* v. *Sternberger's Estate,* 348 U.S 187 (1955), the Supreme Court had to pass on the deductibility of a bequest to charities that would take effect only if the decedent's daughter died without descendants surviving her and her mother. At the time of the decedent's death, his daughter was divorced, had not remarried, and had no children. Before the Tax Court, the decedent's executor introduced actuarial tables to establish the probability of the daughter's remarrying and having a child. On the basis of this evidence, the Tax Court allowed a deduction of about $180,000, representing the value at the time of the decedent's death of a conditional bequest of about one-half of a $2,000,000 estate. (The charities also had a possibility of taking the balance, but this was dependent on the death of certain other relatives as well as on the daughter's dying without descendants, and the estate made no claim for a deduction of this part.) The Court of Appeals for the Second Circuit affirmed The Supreme Court reversed, resting primarily on Sec. 81.46(a) of Regs. 105, providing in part:

> If as of the date of decedent's death the transfer to charity is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charity will not take is so remote as to be negligible.

The Court also argued that the actuarial tables were misleading because they did not, and presumably could not, reflect the daughter's pecuniary incentive, created by the terms of the trust itself, to remarry and have children. To the executor's argument that Sec. 81.44 of Regs. 105 provides for a deduction of the actuarial value of a remainder bequeathed to charity, the Court answered that this provision of the regulations is restricted to "deferred, but assured, bequests." It explained the *Ithaca Trust Co* case as follows: "Where the amount [of the conditional bequest to charity] has been determinable, the deduction has . . . been allowed where the designated charity has been sure to benefit from it." Mr. Justices Reed and Douglas dissented.

Suppose the life beneficiary of a trust, the remainder of which will go to a charity, is to receive an annuity that, if he greatly outlives his life expectancy, will exhaust both the income and the principal of the trust. Will the actuarial value of the charitable bequest be deductible? Does the annuitant have an incentive to live carefully? According to an old saw, "Annuitants never die; pensioners live forever."

In *Dean* v. *United States,* P-H Fed. Tax Serv. ¶ 132,632 (D Mass. 1953), decided before the *Sternberger* case, the court allowed a deduction for a charitable remainder that would be defeated if a woman aged 82 survived two women aged 67 and 68. The court held that the possibility that the charitable bequest would be defeated was so remote as to be negligible; the actuarial value of the conditional charitable bequest was 91 per cent of the value of the corpus.

4. What is the effect of a charitable bequest that is conditioned upon specified action by the recipient, for example, to Yale, to establish the Josef Djugashvili Professorship of Political Economy? See *Churchill* v. *United States,* 68 F.Supp. 267 (E.D. Wisc. 1946); Regs. 105, Sec. 81.46; Annotation, 169 A.L.R. 149 (1947).

5. The decedent executed a will by which he made certain charitable bequests, and died within 30 days thereafter. The law of his state (Pennsylvania) provided that bequests for charitable or religious uses made by will within 30 days of death "shall be void and go to the residuary legatee or devisee, heirs or next of kind, according to law." The residuary legatees waived any objection to a distribution of the estate according to the terms of the will, however, and the probate court ordered distribution to be made accordingly. The Tax Court held that because of the state statute the attempted gift to charities were void so that there were no "bequests, legacies, devises,

or transfers" *from the decedent*, and that what the charities received were gifts from the residuary legatees. The "disclaimers" were held to be irrelevant, on the ground that the parenthetical clause of §2055(a) permits a deduction only if an interest "falls into" a bequest, *etc.*, as a result of the disclaimer. The court distinguished two similar cases allowing the deduction on the ground that the state statutes there involved made the charitable bequests "voidable rather than void." (In fact, one statute used the term "void" and the other the term "invalid.") *Estate of Carey* v. *Commissioner*, 9 T.C. 1047 (1947), aff'd without opinion sub nom. *Marine Nat. Bank* v. *Commissioner*, 168 F.2d 400 (3d Cir. 1948). See *Dumont's Estate* v. *Commissioner*, 150 F.2d 691 (3d Cir. 1945), holding that an amount paid to a charity under a compromise agreement was deductible, in reliance on *Lyeth* v. *Hoey*, *supra*, p.125. See also Rev. Rul. 145, 53-2 C.B. 273; *Robbins* v. *Commissioner*, 111 F.2d 828 (1st Cir. 1940).

6. Note that §2055(c) limits the deduction to the amount actually to be received by the charity, that is, to the value of the transfer after all death taxes. Before the enactment of this provision the Supreme Court allowed the deduction of the full value of a residuary estate left to charities despite the fact that they would receive only that amount *less* the federal and state transfer taxes. *Edwards* v. *Slocum*, 264 U.S. 61 (1924). In *Harrison* v. *Northern Trust Co.*, 317 U.S. 476 (1943), the taxpayer contended—after the statute had been amended—for a similar result on the ground that the federal estate tax was not "payable . . . out of" the residuary (charitable) bequest because under Illinois law it was a *charge* against the entire estate, though its ultimate *burden* was admittedly on the residue. The Court held that "Congress used the words 'payable out of' in the sense of 'diminished or reduced by' the payment of the tax." The computation of tax in such cases requires the use of algebraic formulas, details of which may be found in the loose-leaf tax services; see also Burstein and Stein, "Computation of Estate Tax When Interdependent Deductions Are Present," 29 *Taxes* 455 (1951).

Section E. The Marital Deduction: Section 2056

The material *supra*, pp. 1017–25, should be reviewed at this point.

ESTATE OF PIPE v. COMMISSIONER

Tax Court of the U.S., 1954
23 T.C. 99

Opper, *Judge*:

A deficiency of $21,861.98 in estate tax is here being contested, of which $19,310.29 is in controversy. The sole issue is whether decedent's disposition of certain property qualifies for the marital deduction provided by section 812(e), Internal Revenue Code of 1939 [§2056, 1954 Code].

All of the facts have been stipulated. They are found accordingly. The estate tax return was filed with the collector for the fourteenth district of New York. Decedent, who died a resident of White Plains, New York, on September 20, 1948, was survived by his widow who became executrix of his estate.

The will which was admitted to probate November 10, 1948, after devising to his wife all real property absolutely and forever, together with certain personal effects, provides in part:

Third: All the rest, residue and remainder of my estate, of whatsoever nature and wheresoever situated, hereinafter referred to as my "residuary estate," I give, devise

and bequeath to my wife, Nettie M. Pipe, to have and to hold the same for the term of her natural life, with full power to use, enjoy, sell or dispose of the income and principal thereof, or any part thereof, for such purposes or in such manner as she in her uncontrolled discretion may choose, it being my desire to place no restraint on her in any respect concerning the absolute right of full disposition and use of the whole or any part of said income or principal of my residuary estate, except that she shall have no power over the disposition of such part thereof as remains unexpended at the time of her death.

I direct that my said wife shall not be required to file any bond or other security for the protection of any remainderman interested in my said residuary estate, and she shall not be limited in investing and reinvesting the same to securities of the kind authorized by law for the investment of trust funds. During the life of my said wife, any stocks, bonds or other securities may be registered in the name of my said wife alone as if she were the absolute owner of such property, and no one dealing with her with respect to my residuary estate shall be responsible for the application of any proceeds of sale or other disposition of property.

Fourth: On the death of my said wife * * * I give and bequeath all * * * of the property which can be identified at my wife's death as a part of my residuary estate * * * absolutely, to [certain named legatees].

The value at the optional valuation date of the property passing under article Third of the will was $217,429.84, all of which was included in the gross estate.

The question presented involves the construction of section 812(e) of the estate tax law as enacted in 1948: Does property bequeathed to a surviving wife for life, with unlimited powers of invasion or disposition during her lifetime, but with remainders over as to any residue left at her death, qualify for the marital deduction or does the wife acquire merely a "terminable interest" included in the exception provided in subsection (e)(1)(B) of the same section [§2056(b)(1), 1954 Code].

Petitioner's contention that what the wife took is the equivalent of a fee and consequently cannot be "terminable" does not seem to be advanced with any great conviction. It is in fact inconsistent with petitioner's own alternative argument and with an analysis of the New York law.

Section 149, New York Real Property Law, applicable as well to personalty, modifies the Rule in *Shelley's* Case by providing:

Where an absolute power of disposition, not accompanied by a trust, is given to the owner of a particular estate for life * * * such estate is changed into a fee absolute *in respect to the rights of creditors, purchasers and incumbrancers, but subject to any future estate limited thereon, in case the power of absolute disposition is not executed* * * * [Emphasis added.]

The intention of the testator is, as always, paramount.

Thus, in *In re Mead's Will*, 115 Misc. Rep. 481, 190 N.Y.S. 123, the Surrogate was of the opinion that remainders over were not established with sufficient assurance to restrict the application of section 153, New York Real Property Law, so that the power of disposition by the life tenants was "absolute";[1] while in *Terry* v. *Wiggins*, 47 N.Y. 512, a provision similar to that now before

[1] But see In Re Davies' Estate, 242 N.Y. 196, 151 N.E. 205, 206, where the language of the will was similar to that now in controversy. "* * * as legatee he [the husband] received a life interest therein, with power 'to expend the principal as he may see fit,' and even though the power to expend was untrammeled by any conditions, it did not include the right to transfer it to himself so that he might hold it in fee absolute."

us was said to "clearly indicate an intention" to limit the wife's power of disposition to her life so that "By the will, the wife took an estate for life, . . . with remainder over at her death to the religious society, with power in the wife during the continuance of the life estate to defeat the remainder . . . ," a description sufficiently apt to be applicable to the present situation. . . .

Inconsistently, as it seems to us, petitioner insists as an alternative that what was accomplished was the creation of a trust, of which the wife was trustee and life beneficiary, with remainders over, but with an unqualified lifetime power over the corpus not only of disposition but of enjoyment and consumption. This is said to bring the situation within section 812 (e) (1) (F).*

That the life tenant in possession is often loosely referred to by the term "trustee" in the New York cases cannot be denied. The references fall generally into two groups. In some, such as *Smith et al* v. *Van Ostrand,* 64 N.Y. 278, for example, a restriction is placed by the will on the invasion of corpus. In that case only so much as was necessary "to her support" could be taken from principal. In *Leggett* v. *Stevens,* 185 N.Y. 70, 77 N.E. 874, the use was permitted by the surviving wife "for her own comfort and support." In other instances the bequest has been construed as forbidding any invasion even with language like "use and enjoy" the property, as in *In re McDougall,* 141 N.Y. 21, 35 N.E. 961, 963:

* * * On the contrary, we think the testator meant to give the widow nothing but an estate for her life or widowhood, terminable at the happening of either event, and that the remaindermen were entitled to receive at such time the *whole* corpus of the estate. [Emphasis added.]

See also *In re Ungrich,* 48 App. Div. 594, 62 N.Y.S. 975, affd. *per curiam* 166 N.Y. 618, 59 N.E. 1131; *In re Hamlin,* 141 App. Div. 318, 126 N.Y.S. 396. The employment of the trust concept in such situations is even less significant on the present point.

Where the power of disposition and invasion, though restricted to the period of the life tenancy, is unlimited, the "trust" if any is said to attach not to the property received by the life tenant, but at most to that which remains on his death. That is apparently the outer limit of the present situation.

The rule is enunciated in *Seward* v. *Davis,* 198 N.Y. 415, 91 N.E. 1107

* * * It is doubtless true that *ordinarily* a life tenant in possession of personal property is a trustee to *preserve the principal* for the remaindermen to whom it may pass on his death In this case, however, *the widow had the right to dispose of the property in her lifetime, and as to such property as she did dispose of* neither she nor her executor was bound to account to the remaindermen because they had no interest in it. * * * [Emphasis added.]

As petitioner expresses it, the question in that case "was the quantum of the trust with respect to which her executor must account· Was it the full amount she received from her husband's estate *or merely the amount which remained undisposed of at her death?*" [Emphasis added.]

We think it follows that even if there was an implied trust here, and even if, contrary to respondent's contention, such a "trust" is covered by section 812

* From 1948 to 1954 the statute provided that a trust under which the surviving spouse had the right to the income for life, plus a power to appoint the entire corpus free of the trust, qualified for the marital deduction. In 1954 the statute was amended to provide that a life estate with power to appoint, as well as a life interest under a trust, will qualify. §2056(b)(5). [Ed]

(e) (1) (F), and even if, in spite of the apparent language of the New York statute,[2] the wife could then use for herself the corpus of the trust, as obviously the testator intended, and even if that question is to be governed by the local law of each of the 48 states, but *cf. Lyeth* v. *Hoey*, 305 U.S. 188, still the corpus constituting this trust would not only be less than the total share left to the wife, see *Estate of Louis B. Hoffenberg*, 22 T.C. 1185 (1954), but it would be so indefinite as to render impossible of identification at decedent's death what property is subject to the trust and therefore intended to be covered by section 812 (e) (1) (F). This seems to us an adequate reason for presuming that it was not the congressional intent to include this type of "trust" in the marital deduction provisions of that subsection.

Generally speaking, the "terminable interest" concept was devised for the purpose of assuring that if the property bequeathed to the spouse was to be excluded from gross estate with respect to the decedent, it would be adequately integrated in the spouse's estate so that on her death it would not escape the death tax a second time. As petitioner expresses it

> The basic principle * * * is that the spouse first to die shall be permitted to pass on to the surviving spouse free of estate tax up to one-half of his or her estate, provided only that the terms of the transfer are such that this property will be taxable in the estate of the surviving spouse.

In the premises, the existence and scope of any "trust" established for the wife by decedent is so doubtful that it would scarcely seem logical to include the property in the wife's estate, if, when she dies, the corpus has neither been consumed nor donated. In that event, her failure to exercise the power of invasion will make it more reasonable to think of the remaindermen as succeeding to property left them by decedent.[3] We think the basic purpose of section 812(e) will hence be more adequately accomplished by considering the wife's interests here as "terminable," and by inclusion of the property in decedent's estate. . . .

Reviewed by the Court.

Decision will be entered under Rule 50.

Note

1. Now that a legal life estate with power to appoint qualifies for the marital

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[2] "* * * A power, vested in a person in his capacity as trustee of an express trust, to distribute principal to himself cannot be exercised by him * * *, if there is no trustee qualified to execute the power, its execution devolves on the supreme court." Sec. 141, N.Y. Real Property Law. [Emphasis added.]

[3] In *Helvering* v. *Safe Deposit Co.* [*supra*, p. 973], the Supreme Court had before it the question of including in gross estate as an "interest" under section 302(a), Revenue Act of 1926, the predecessor of [§2033, 1954 Code], property as to which decedent had a qualified beneficial life estate and a testamentary power of appointment which was unexercised at his death. The question was answered in the negative by a unanimous court. Four of the justices dissenting on another point, used this language: "It is conceded that no part of either estate passed by virtue of the execution by the decedent of the powers of appointment with which he was clothed. The property passed under the deed and wills of his parents, and that passage was the taxable event."

While under §811(F) [1939 Code] property covered by certain unexercised powers of appointment is now taxable, it is evident from the restrictive language of [§2056, 1954 Code] that Congress did not have this simple situation in mind in granting the marital deduction. We do not understand petitioner to contend otherwise.

deduction, §2056(b)(5), would the deduction be allowed on the facts of the *Pipe* case? Why did the court conclude that the value of the unconsumed corpus would not be includible in the widow's estate on her death? Did she have at the time of her death a "general power of appointment" within the meaning of §2041(b)(1)?

In *Estate of Selling* v. *Commissioner*, 24 T.C. No. 26 (1955), also decided under pre-1954 law, the Tax Court denied a marital deduction for the value of renewal commissions earned during life by the decedent, a life insurance agent. He left his wife "all my right, title and interest in and all my claims to . . . renewal commissions on life insurance and/or annuity contracts of any kind, which may become due on or after my decease . . . including the right to sell, assign, transfer or hypothecate any of these commissions, even though they may not yet be due and payable at the time of such sale, assignment, transfer or hypothecation. . . ." Commissions not paid to the wife or sold, assigned, *etc.*, by her were to go, under his will, to their son. The court held that under state law the wife's interest "was not the equivalent of a fee but was at most a life estate with power of disposition which would terminate at her death with the remaining commissions not then due passing to the son." Would the interest be deductible under the 1954 law? Would the wife's estate include the amount for which she could have sold the renewal commissions not yet paid to her?

2. In the *Pipe* case, the widow's power of invasion was unlimited. The transfer would have been ineligible *a fortiorari* if she had possessed only a restricted power of invasion. See *Estate of Melamid* v. *Commissioner*, 22 T C. 966 (1954), where the widow could use as much of the estate "as she may need for the way of life to which she and I have been accustomed." See also Rev. Rul 55-395, 55-1 C. B. —, stating that the marital deduction would not be allowed for a trust under which "the trustee shall use the net income therefrom for the care, maintenance and support of [the] widow in such fashion and state *as she may desire*, with the power in the trustee, in the event such income should be insufficient to meet *her desires or demands*, to sell trust assets from time to time and use the proceeds for the purposes aforesaid."

See also *Estate of Peterson* v. *Commissioner*, 23 T.C. No. 126 (1955), denying the marital deduction for property passing under a joint and mutual will executed by the decedent and his wife, on the ground that under state law she received only a life estate with a limited power to consume. The will provided that the first to die willed to the survivor "absolutely and forever all of . . . his estate" and that the survivor willed his estate, less any part used for his own benefit "in his or her sole discretion," to their children. Compare *Estate of Awtry* v. *Commissioner*, 221 F.2d. 749 (8th Cir. 1955), reversing 22 T.C. 91 (1954).

3. Section 2056(e)(3) refers to dower interests. But if under local law, the widow's dower interest consists of the right to the income from the decedent's real property until her death or remarriage, does the value of her dower interest qualify for the marital deduction? What if her interest is commuted, by consent of all interested parties, to a cash payment? Rev. Rul. 279, 53-2 C B. 275.

4. On the requirement of §2056(b)(5) that the surviving spouse must be "entitled for life to all the income . . . payable annually or at more frequent intervals," see Regs. 105, Sec. 81.47a(c), which deals with the effect of powers in the trustee to allocate receipts and charges between income and corpus, to retain unproductive property, to amortize bond premium, *etc.*

REV. RUL. 55-277

Internal Revenue Service, 1955
1955-1 C.B.—

Advice has been requested concerning the estate tax marital deduction provisions of section 812(e) of the Internal Revenue Code of 1939 as applied to the proceeds of life insurance under the circumstances set forth below.

In the instant case a policy of insurance provides that the proceeds of the policy were to be retained by the insurance company and interest thereon paid

monthly to the surviving spouse during her life. The wife was given the right, exercisable by her alone and in all events, to direct the insurance company to pay the entire proceeds of the policy at her death to her executors, administrators or assigns. The specific question is whether the spouse possessed a power of appointment within the meaning of section 812(e)(1)(G)* of the Internal Revenue Code qualifying the proceeds of the policy for the marital deduction under section 812(e) of the Code. . . .

The provisions contained in the policy to the effect that the surviving spouse had the right to direct payment of the proceeds to her "executors, administrators or assigns" is a power to appoint to "the estate of such surviving spouse" within the meaning of section 812(e)(1)(G) of the Code, *supra*. Accordingly, it is held that since the wife is entitled to the income for life and the right, exercisable by her alone and in all events to direct the insurance company to pay the entire proceeds of the policy at her death to her executors, administrators or assigns, the insurance qualifies for the marital deduction under section 812(e) of the Code. . . .

The decision in *Second National Bank of Danville, Illinois* v. *Dallman*,† which would require a conclusion contrary to that reached herein, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations.

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* This provision is now §2056(b)(6), except that if the surviving spouse has the right to appoint a "specific portion" of the insurance payments, instead of "all amounts," the specific portion subject to the power of appointment now qualifies for the marital deduction, as a result of a 1954 change. [Ed.]

† *Supra*, p. 977. The portion of the opinion omitted *supra* held that the decedent did not have a general power of appointment under the 1942–48 law, for the following reasons:

"Paragraph 3 of subsection 811(f) [1939 Code] defines a general power of appointment thus: 'For the purposes of this subsection the term *general power of appointment* means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate * * *' . . We think it obvious that decedent had no general power of appointment and certainly she was not endowed with power to dispose of the insurance proceeds by will. This power of appointment of which the statute and the cases speak is not something to be plucked out of the air, it must be created before it can be exercised. Decedent's power, such as it was, must be found in the insurance contract between her father and the insurance company and not elsewhere.

"The salient provisions of this contract have heretofore been noted and need not be repeated in detail. It is sufficient to state that the sole and only power reposed in decedent was the right to appoint a contingent beneficiary. If this power had been exercised, which it was not, the beneficiary thus appointed would have been entitled to take the insurance proceeds. And even the exercise of this meager power was limited, that is, it was required to be made in 'writing and filed at the Home Office of the Company (accompanied by the Policy for suitable endorsement) prior to or at the time this Policy shall become payable.' It thus appears plain that as a prerequisite to any valid change of beneficiary, decedent was required not only to nominate but also to take the prescribed steps in order to make such nomination effective, all to be performed prior to her death. This was not done, and as a result the proceeds were payable at decedent's death not by her direction but by that of her father as contained in the contract. There is not so much as an intimation in the contract of any right possessed by decedent to dispose of the proceeds at her death, by will or otherwise. Every vestige of right or interest which decedent had in these proceeds was extinguished by death; nothing passed from her to the executor of her estate. Any exercise of power in this respect by decedent in her testamentary capacity must have been of her own creation, it certainly was not that of her father.

"We have examined the many cases called to our attention and we find none where the right to make a disposition of property, testamentary or otherwise, by power of appointment was not derived from a donor. . . ." (209 F.2d at 323–4.) [Ed.]

Note

1. Why would the *Danville Bank* case require a contrary conclusion?

2. Suppose an insurance settlement option provides that the insured's surviving spouse shall receive the proceeds in a stated number of monthly installments, any installments due after her death being payable to contingent beneficiaries. If the surviving spouse during the insured's life could have elected instead to have the proceeds paid to her in a lump sum upon her husband's death, but lost this power by failing to exercise it before her husband's death, is the marital deduction allowable? *Estate of White* v. *Commissioner*, 22 T.C. 641 (1954)

3. While the wife's right to take can be conditioned, by virtue of §2056(b)(3), on her surviving her husband by six months or more (or on surviving a common disaster) without making her interest "terminable," other conditions of survivorship may be fatal. In *Kasper* v. *Kellar*, 217 F.2d 744 (8th Cir. 1954), it was held that if the wife would take only if she was living when her husband's estate was distributed, her interest was "terminable" and would not qualify for the marital deduction even though distribution to her did occur within six months after the husband's death. In Rev. Rul. 54-121, 54-1 C.B. 196, the Internal Revenue Service ruled that insurance proceeds received by the decedent's widow would not qualify for the marital deduction if she was to take only if alive when the insurance company received due proof of the insured's death, since that might occur more than 6 months after his death.

See also *Estate of Tingley* v. *Commissioner*, 22 T.C. 402 (1954) (appeal pending) where the surviving spouse's power to invade the corpus of a trust (of which she was the income beneficiary) would terminate upon her legal incapacity or upon the appointment of a guardian of her person or property. The Tax Court held that she did not have the right to appoint the corpus "in all events," as required by §2056(b)(5)

> If he [the decedent] had referred to legal incapacity alone, the situation might well be different for any surviving spouse with a power to appoint by will could later lose the power by becoming legally incapable of writing a will exercising the power and Congress may not have intended that such an event by operation of law would deny the marital deduction wherever the power was to be *[sic]* by will But this testator intentionally made the right to enjoy the income for life and the power to take down the corpus depend upon events not synonymous with legal incapacity. Conditions short of legal incapacity could bring about the appointment of a guardian, conservator or other custodian of the estate of the widow and the decedent chose to cut off his wife's rights should any such event occur. Thus, he named events under which she could not exercise the power and it was not exercisable "in all events" as required by [§2056(b)(5)]

4. Before the 1954 change in §2056(b)(5) and (6), the surviving spouse's power of appointment had to extend to the entire corpus, in the case of a trust, or to all amounts payable under the contract, in the case of insurance proceeds. If the power of appointment extended to only part of the corpus or insurance payments, not even that portion would qualify, although it would be part of the surviving spouse's estate (if not previously consumed or disposed of) on her death. In denying a marital deduction to any part of a testamentary trust under which the surviving spouse was to receive two-thirds of the income for life and could appoint one-half of the corpus, the Tax Court said·

> It is true that with only a few additions to the second codicil and with only minor substantive changes the decedent could have created a separate trust of one-half the residue of his estate in favor of his wife which could have easily qualified under section 812(e)(1)(F) [of the 1939 Code] . . But . . . if the statute so reads, the liability for tax can depend upon whether or not a separate trust was created. (*Estate of Shedd* v. *Commissioner*, 23 T.C. 41, 45 (1954).)

In coming to this conclusion, the Tax Court rejected the taxpayer's argument that the 1954 change was intended only to clarify the pre-1954 law. See also *Estate of Hoffenberg* v. *Commissioner*, 22 T.C. 1185 (1954), affirmed p.c. — F.2d — (2d Cir. 1955), Rev. Rul 54-553, 54-2 C.B. 303.

5. *Formula clauses.* The marital deduction can equal, but it cannot exceed, 50 per cent of the adjusted gross estate §2056(c)(1) If all of the property included in the husband's gross estate is left to the wife, the husband's estate is sure to get the maximum marital deduction.* But his wife's estate, on her death, may then be needlessly large, if she lives on the income alone, 50 per cent of the family fortune will have been taxed on the husband's death and 100 per cent on her death. Partial protection against two taxes in rapid succession can be obtained by providing that the wife will take nothing if she dies either in a common disaster with her husband or from any cause within 6 months after his death. If she does die in a common disaster or within six months, the husband's estate will be taxed on 100 per cent of the family property (since no property passes to the wife, no marital deduction is allowable), but there will be no tax on her death. On the other hand, if the wife does not die in a common disaster or within 6 months of her husband, the interest passing to her qualifies for the marital deduction, §2056(b)(3) saves it from the category of "terminable interest." But then the family will be subjected, as indicated above, to two taxes, one on 50 per cent, and the second on 100 per cent, of the family property.

Until 1954, moreover, the wife's estate could not get a deduction for the property previously taxed to her husband's estate, even though her death occurred within the 5 year period that then governed the deduction for previously taxed property.† This was because in 1948, when the marital deduction was enacted, it was recognized that property that had qualified for the marital deduction in the husband's estate had not been "previously taxed." If the wife's estate had been allowed to deduct property inherited from the husband that had qualified for the marital deduction, there would be a tax on 50 per cent of the family property when the husband died and no tax at all when the wife died, provided the husband left half of his estate to the wife outright and the other half either to the children or in trust for the wife with remainders to the children. But instead of denying the previously taxed property deduction only to property that had qualified for a marital deduction in the previous estate, the 1948 Act denied it to any property received by one spouse from another, even if the inherited property exceeded the amount of the marital deduction or even if no marital deduction had been allowed (Technical difficulties were apparently thought to compel this undiscriminating approach to interspousal transfer.) When the previously taxed property provision was revised in 1954, however, its benefits were restored for property received by one spouse from another, with the restriction that only the excess over the prior estate's marital deduction will qualify. §2013(d)(3). Because of this change in 1954, there is less danger than formerly that a husband's transfer of all of his property to his wife will produce the dreaded combination of a tax on 50 per cent and then a tax on 100 per cent of the family property within a brief period.

But the danger is not removed, since if the deaths are more than 2 years apart, §2013(a) grants only a partial credit for the tax on the prior transfer. Consequently, the pressure to minimize the wife's estate while securing the largest possible marital deduction for the husband was alleviated without being totally relieved by the 1954 amendment to §2013.

If the husband's entire gross estate passes under his will, a bequest of one-half to his wife (outright or in the form of a life estate with power of appointment) will insure the maximum marital deduction. The other half can be left to the children, to the wife for life with remainders to the children, to the wife for life with a non-general power of appointment, or by some other disposition that will not bring it into her estate. It is sometimes assumed that if the husband leaves the wife enough property outright to insure that his estate will get the maximum marital deduction and leaves everything else in such a form that it will not be included in her estate, the lowest possible aggregate estate taxes will result. Indeed, there are tables and formulas and even a handy slide rule to compute in dollars the tax savings that such a disposition

* The discussion that follows assumes that the husband's estate does not include any property transferred during his life (*i e.*, that it is identical with the probate estate) and that the wife has no property of her own.

† *Infra*, p. 1232.

will produce, as against leaving everything to the wife outright or leaving her less than enough to secure the maximum marital deduction. But *will* the tax savings necessarily be realized? What if tax rates change? What if there are wide fluctuations in property values? What if the wife does not use all of the income from the property left to her and reinvests the unconsumed portion?

If when the will is drawn the testator knows or expects that his gross estate will include non-probate property, such as insurance proceeds payable to designated beneficiaries, jointly-held property, gifts in contemplation of death, *inter vivos* trusts, *etc.*, it is more difficult to insure that the estate will obtain the maximum marital deduction. If the *inter vivos* transfers were to persons other than the wife, she must get more than one-half of the probate property, if full advantage is to be taken of the marital deduction. If the transfers outside the will were to the wife, however, she must get less than one-half of the probate property lest her estate be unnecessarily increased. A proposed "formula clause" to give the wife an amount which will insure the maximum marital deduction, but no more, is as follows·

> If my wife survives me, I devise and bequeath to her a portion of my estate the value of which shall be exactly the sum needed to obtain the maximum marital deduction in determining the Federal estate tax on my estate after taking into account all the other items of my gross estate (whether passing under this Will or otherwise) that qualify for said deduction. In computing the value of the property, if any, passing under this clause, the final determinations (whether by agreement, litigation or otherwise) in the Federal estate tax proceeding shall control, and only assets that qualify for said deduction shall pass under this clause, at their values as finally determined for Federal estate tax.

Some commentators have speculated about the possibility that a formula clause of this type may improperly incorporate by reference a document, the Internal Revenue Code. that may be changed after the will has been executed Others have suggested that the rule against perpetuities may be violated, since the estate tax values, which control the amount of the bequest, will not necessarily be ascertained during the perpetuities period. But most writers have expressed the view that formula clauses are valid, if for no other reason than judical reluctance to upset a testamentary pattern that is now widely used. See also *Braun* v. *Central Trust Co.*, 104 N E. 2d 480 (Ohio, 1951), rejecting the argument that a formula clause violates the rule against perpetuities; Conn. Gen. Stats., 1953 Supp., §2204c, providing that wills may refer to federal statutes or regulations governing the marital deduction as a means of computing the amount of a bequest.

Even though the formula clauses are not invalid, they may pose difficult problems of administration for the executor Consider the effect of an *inter vivos* gift to a child that the government asserts was made in contemplation of death. If it is included as a gift in contemplation of death, the formula clause may increase the surviving spouse's share of the probate estate. Must the executor resist the government's claim with especial vigor lest the heirs claim he is favoring the wife? Because of the gift tax credit of §2012, it is possible that inclusion of such a gift will not increase the estate tax. If so, could the executor properly spend funds of the estate to litigate the contemplation of death issue? If the *inter vivos* transfer in question was a gift to the surviving spouse rather than to a child, how will the formula clause affect the executor, the surviving spouse, the other heirs, and the tax collector? The executor may find the formula clause troublesome at other points as well, *e.g.*, in deciding whether to emplov to optional valuation date of §2032 or to take deductions on the income tax return instead of on the estate tax return, *supra*, p. 1204, since his decisions on these matters may affect the size of the surviving spouse's share under the formula clause.

For a stimulating debate on the use of formula clauses, see Trachtman, "Leaping in the Dark More Adventures with Marital Deduction Formulae," 1954 *Proceedings of Probate and Trust Law Divisions, American Bar Association*, p.98, and Sargent, "To Each His Own," *ibid.* 117. See also Trachtman, "'Common Disaster' Clauses; Disclaimers, Marital Deduction—'Formula Clause,'" *8th Ann. N.Y.U. Inst. on Fed.*

Taxation 304 (1949); Lourie, "Considerations in Determining How Much Marital Deduction to Use in a Will," *ibid.* 313; Siskind, "MMDF Nightmares," 28 *Taxes* 802 (1950); Spinney, "A Marital-Deduction Trust Nontax-Formula Will Clause," *ibid* 855

Are there circumstances that would make it desirable to forego the marital deduction entirely?

See generally Trachtman, *Estate Planning* (P.L.I. Current Problems in Federal Taxation, 1951); Casner, "Estate Planning—Marital Deduction Provisions in Trusts," 64 *Harv. L. Rev.* 582 (1951), Dibble and Stutsman, "T.D. 5698 and T.D. 5699. The Second Step in the Application of New Concepts of Federal Estate and Gift Taxation," 22 *So. Calif. L. Rev.* 364 (1949), Sargent, "A. B. C. and D. of Marital Deduction," 92 *Tr. and Estate* 746 (1953); Fleming, "Five Years' Experience with the Marital Deduction," 34 *Chi. Bar Record* 247 (1952); Smith, "Marital Deduction in Estate Planning," 32 *Taxes* 15 (1954).

Section F. Credits against the Tax

After the estate tax has been computed by applying the rates set out in §2001 against the "taxable estate" (*supra*, p. 1202), certain credits are computed and applied against the tax thus computed. These credits are allowed for (1) state death taxes paid with respect to any property included in the gross estate, (2) death taxes paid to any foreign country in respect of any property situated in that country and included in the gross estate, (3) federal gift taxes paid on the transfer of property that falls into the gross estate, and (4) an appropriate part of the federal estate tax paid by another estate from which the current decedent received property within a ten-year period.

1. Credit for State Death Taxes: Section 2011

PERKINS
STATE ACTION UNDER THE FEDERAL ESTATE TAX CREDIT CLAUSE

13 N. C. L. Rev. 270–73, 277, 279–81 (1935)
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In the spring of 1925 the Alabama Power Company proclaimed the opportunities of the state whose name it carries by a series of advertisements of this nature: "Who Gets Your Estate When You Die? That all Depends on Where You Live, What You Own and Where You Die. Taxation Figures of the H. C. Frick Estate as Published in the 'Nation's Business' are a striking example: Federal Tax, $6,338,898.68; Pennsylvania State Inheritance Tax, $3,167,197.87; Other Inheritance Taxes, $1,546,565.49. If the H. C. Frick estate had been in Alabama and the testator had been a resident of Alabama, his state inheritance tax would have been Nothing!" Another advertisement in the series thus explained to the prospective decedent this elysian state of affairs: "No Inheritance Tax Under Alabama Constitution. Not only has Alabama no Income nor Inheritance Tax but the framers of the Alabama Constitution have gone so far as to make sure that No Inheritance Tax Can Be Levied by the Alabama legislature on estates left to

lineal descendants. Alabama is the Only State of Industrial Vantage Which Has Neither Income Nor Inheritance Tax. Profits Made in Alabama Pass to Heirs!"

In the fall of the preceding year Florida amended her constitution in order to prohibit the taxation of inheritances and the taxation of incomes of residents of that state. Florida had never had either an inheritance tax or an income tax. Also it has been said that under her then existing constitution Florida could not have an inheritance tax and that this amendment was but a reiteration of the state's fundamental law. Such an amendment with its necessarily attendant publicity appeared to be an advertisement that Florida would be a permanent refuge from inheritance taxation. The legislature of Nevada in February 1925 followed up this procedure by repealing that state's inheritance tax act of twelve years' standing.

Into this movement came a clause of the federal estate tax which has resulted in the abolition of inheritance tax havens. A consideration of this device as an agency in the elimination of interstate tax competition is the purpose of this article.

Under the Revenue Act of 1921 the federal estate tax was graduated from a rate of one per cent on the first fifty thousand dollars to a maximum of twenty-five per cent on the excess over ten million. The bill reported by the Ways and Means Committee in 1924 carried these same rates. However, during the consideration of this bill Congressman Ramseyer of Iowa offered an amendment which would sharply increase the rates in the higher brackets and reach a maximum of forty per cent. Opponents of the higher rates became defenders of the states' taxing preserves. It was argued that the field of death taxes belonged preeminently to the states, had been occupied by the federal government only in emergencies, and that to increase these rates in a period of tax reduction would be a declaration of permanent occupancy. The advocates of higher death taxes likewise feared that increased federal rates might embarrass the states by decreasing the amount which the states could exact, and would heighten state competition for the wealthy. These advocates proposed a novel arrangement to protect the states and to promote uniformity in the size of state inheritance tax rates. Congressman Green, of Iowa, Chairman of the Ways and Means Committee, was the author of this device. It was introduced on the floor of the House by Congressman Frear of Wisconsin as an amendment to the amendment offered by Congressman Ramseyer. The amendment provided that:

> The tax imposed by this section (the federal estate tax) shall be credited with the amount of any estate, inheritance, legacy or succession taxes paid any state, territory, or the District of Columbia with respect to any property included in the gross estate. The credit allowed by this subdivision shall not exceed 25 per cent of the tax imposed by this section.

With but little discussion the House adopted the amendment *viva voce*, and without discussion at all on the floor of the Senate, it became part of the Revenue Act of 1924. At that time the movement threatening the elimination of state inheritance taxation was not in full swing, and the primary reason for the creation of the twenty-five per cent credit appears to have been the desire to protect state revenues in the face of the increased federal rates. It was not until 1926, when the credit had been increased from twenty-five to eighty per

cent, that the clause fully assumed its role of protector against interstate competition. . . .

What has been the effect of this innovation in federal taxation, and how have the states reacted to it? What changes were caused, first by the twenty-five per cent credit, and later by the eighty per cent clause? . . .

The first steps were taken by New York, Pennsylvania and Georgia in 1925. New York passed an estate tax which applied to estates of residents in excess of one million dollars and with rates exactly one-fourth of the federal rates. This change enabled New York to absorb the federal credit on the larger estates, and the New York inheritance tax, which remained in effect, appears to have been sufficiently high to absorb the credit for smaller successions. Pennsylvania also adopted an estate tax, but with the simple specification that the tax should be equal to twenty-five per cent of the federal tax where this twenty-five per cent was as much or more than the existing Pennsylvania inheritance tax; otherwise the inheritance tax rates should apply. Georgia provided that the only death tax which should be paid by estates of residents should be an estate tax equal to twenty-five per cent of federal estate tax, and with that stroke diminished the death tax advantages of her neighbors, Florida and Alabama.

The next year the credit was increased to eighty per cent,* and in the two succeeding years seventeen states took action to secure its benefit. The number has increased gradually so that now thirty-six states have acted. Although there are variations in phraseology, half of the states can be grouped together under statutes which, in addition to their regular inheritance taxes, impose estate taxes on the estates of resident decedents. The amount of such estate tax is the difference between the possible federal credit—eighty per cent of the federal tax—and the aggregate of all inheritance taxes paid to the domiciliary state and to other states. A slightly different approach utilized in a few states is the imposition of an estate tax equal to eighty per cent of the federal tax, with provision for a credit against the state tax for all other inheritance taxes. Another group of states impose the additional estate tax on estates both of residents and non-residents, the amount of the tax being the difference between the inheritance tax due the particular state and eighty per cent of the federal tax due on the portion of the estate within the jurisdiction. Although the large majority of the states have both inheritance and estate taxes, New York and Mississippi have substituted the estate tax as the only death tax, and provide schedules of rates which absorb the federal credit.

Note

1. The constitutionality of the credit was attacked without success by the State of Florida in ***Florida* v. *Mellon,*** 273 U.S. 12 (1927). The Supreme Court said, among other things:

> The contention that the federal tax is not uniform, because other states impose inheritance taxes while Florida does not, is without merit. Congress cannot ac-

* The maximum credit was fixed at 80 per cent of the Federal *basic* estate tax, no credit was allowed against the federal *additional* estate tax. When the basic and additional taxes were combined into a single federal estate tax by §2001 of the 1954 Code, the maximum allowable credit for state death taxes was set out in a table, §2011(b), and a method was provided for computing a "basic estate tax" to avoid disturbing state statutes which refer to this concept. Section 2011(d), see *supra*, p. 1202. [Ed.]

commodate its legislation to the conflicting or dissimilar laws of the several states, nor control the diverse conditions to be found in the various states, which necessarily work unlike results from the enforcement of the same tax. All that the Constitution (article 1, §8, cl. 1) requires is that the law shall be uniform in the sense that by its provisions the rule of liability shall be alike in all parts of the United States.

The claim of immediate injury to the state rests upon the allegation that the act will have the result of inducing potential taxpayers to withdraw property from the state, thereby diminishing the subjects upon which the state power of taxation may operate. The averment to that effect, however, affords no basis for relief, because, not only is the state's right of taxation subordinate to that of the general government, but the anticipated result is purely speculative, and, at most, only remote and indirect. *Minnesota* v. *Northern Securities Co.*, 194 U.S. 48, 68, 70. If, as alleged, the supposed withdrawal of property will diminish the revenues of the state, non constat that the deficiency cannot readily be made up by an increased rate of taxation. Plainly, there is no substance in the contention that the state has sustained, or is immediately in danger of sustaining any direct injury as the result of the enforcement of the act in question. See *In re Ayers*, 123 U.S. 443, 496; *Massachusetts* v. *Mellon*, 262 U.S. 447, 488

Nor can the suit be maintained by the state because of any injury to its citizens. They are also citizens of the United States and subject to its laws In respect of their relations with the federal government—"it is the United States, and not the state, which represents them as parens patriae, when such representation becomes appropriate; and to the former, and not to the latter, they must look for such protective measures as flow from the status." *Massachusetts* v. *Mellon*, *supra*, pages 485, 486.

An attack by an executor was equally unsuccessful in *Rouse* v. *United States*, 65 Ct Cl. 749 (1928), *cert. den.*, 278 U.S. 638.

See also Cogburn, "The Credit Allowable Against the Basic Federal Estate Tax for Death Taxes Paid to States and State Statutes Enacted to Take Advantage Thereof—Constitutional Difficulty and Some Suggested Solutions," 30 *N.C.L. Rev.* 123 (1952).

2. As may be seen by examining the table in §2011(b), state death taxes may not be credited unless the "taxable estate" exceeds $40,000 (This limitation reflects the history of the credit; as indicated above, it could not exceed 80 per cent of the federal basic tax, in the computation of which an exemption of $100,000 was allowed.) The table also progresses rather slowly, so that the credit does not become substantial until the estate is quite large. Consequently, state death taxes (unless restricted to the amount of the federal credit) represent, for the small estate, a burden in addition to the federal levy. But for the large estate, state taxes are more likely to be in lieu of federal tax liability.

3. No credit is provided against the federal gift tax for state gift tax paid on the same transfer.

4. See generally Perkins, *op. cit.*, *supra;* Oakes, "The Federal Offset and the American Death Tax System," 54 *Q. J. Econ* 566 (1940); Groves, Gulick, and Newcomer, "Federal, State, and Local Government Fiscal Relations," S. Doc. No. 69, 78th Cong., 1st Sess., 476–496 (1943); Maxwell, *The Fiscal Impact of Federalism in the United States* 331–353 (1946).

GROVES, GULICK, AND NEWCOMER
FEDERAL, STATE, AND LOCAL GOVERNMENT FISCAL RELATIONS

S. Doc. No. 69, 78th Cong., 1st Sess., pp. 488–489 (1943)

Certain broad conclusions may be reached with respect to variations in State

death-tax burdens and the ineffectiveness of the present crediting device. The crediting provision has fallen far short of the goal of equalization of the death-tax burdens imposed by the various States. States have not confined their taxes to 80 percent of the Federal schedule of 1926. Instead, they have imposed taxes more than twice as high on the average.* Under the death-tax rates and exemptions which States find necessary to meet their needs, the existing credit provision is not broad enough in scope to effect the desired substantial degree of interstate uniformity and equity. In view, therefore, of the variation which permeates all aspects of State taxes on property transfer at death, and in view of the magnitude of such taxes as compared with the magnitude of Federal credit, it is clear that the existing credit provision is in itself inadequate to eliminate interstate competition and Federal-State conflict in death taxation. However, before rejecting the crediting device in favor of outright centralization in the Federal Government, with State sharing of Federal collections contingent upon complete State withdrawal from the field (whether optional or not), or some other plan of coordination, it would appear desirable to investigate the possibility of changing the percentage credit and relating it to current Federal death-tax revenues in such a way as to make it effective. After all, it must be remembered that most unusual changes have occurred in Federal and State finances since 1926, so that it is not surprising that a Federal-State relationship created in 1926 and left unchanged since then should have become outmoded and ineffectual.

Assuming the possibility of discovering a percentage credit of current Federal estate taxes which would accomplish the purpose intended in 1926, there would seem to be several advantages in further employment of the crediting device as against more coercive methods. The States are with few exceptions committed to the crediting device, are familiar with it, have had experience with it, and are not afraid of it. The States obviously do not now associate the allowance of a Federal credit for death taxes with coercion or infringement of State sovereignty by the Federal Government. It is likewise probable that a transition from one credit arrangement to another could be brought about much more readily than could a transition from the existing crediting provision to some system of centralized collection and State sharing. As quickly as it became apparent to each State that it would gain from the new arrangement, statutory implementation would probably be forthcoming in most cases.

It is even possible that general acceptance of a crediting arrangement which would give to each State as much or more revenue than presently flows from its independent death tax statutes might, in due course, bring about repeal of such statutes and complete reliance upon a simple enactment designed to absorb the Federal credit. Dual administration would become unnecessary and Federal or joint administration could be substituted. The differing structures of Federal and State death-tax laws would become less marked if the Federal law were amended to bring exemptions and rates more nearly into line with corresponding State provisions. The objection raised against the crediting device, to wit, that it fails

* A recent study states that the present federal credit amounts to only about one-third of total state death tax revenues. Analysis Staff, Tax Division, Treasury Department, *Overlapping Taxes in the United States* 57 (1954). [Ed.]

to eliminate the cost of dual administration and of dual compliance, might consequently not be entirely valid. The feasibility of this plan rests upon the development of a crediting formula which will adequately cover the individual position of each State.

An analysis of five hypothetical crediting plans tested for adequacy reveals that the plan which most nearly tends to accomplish the desired purpose is one which allows a credit for State taxes paid of 50 percent of Federal tax liability on the amount of the net estate not exceeding $100,000 and 25 percent on the amount exceeding $100,000, accompanied by a reduction in specific exemption and insurance exemption to a maximum of $20,000 each. Under such a crediting arrangement, the evidence indicates that only the States of North Dakota, Oregon, and Utah might find a tax based on the Federal credit inadequate as a substitute for their current levies. Even North Dakota and Oregon would seem to gain at the lower levels, where most of their estates are likely to be. The rates levied in those States are so far out of line with these of other States that to increase the Federal credit sufficiently to cover them would present all other States with an unnecessarily large increase in death taxes and would result in too great a loss in Federal revenue. But even these States, together with the others, might find it expedient to conform to the proposed Federal credit as the structure of the Federal law is brought more nearly in line with the structure of present State laws, particularly as to the lower estate brackets. As the possibilities of eliminating dual administrative and compliance costs, of establishing uniformity of burden, of stabilizing Federal-State death taxes on a permanent basis, and of achieving other advantages, became more evident to all concerned, added impetus would be given to the movement toward conformity. As previously suggested, the data which must be used as a basis for calculation are so crude that a considerable margin of error must be anticipated.

Note

For a proposal that the federal government surrender the death tax field to the states, see Committee on Postwar Tax Policy, *A Tax Program for a Solvent America* (Ronald Press, 1945), criticized by Groves, "Retention of Estate and Gift Taxes by the Federal Government," 38 *Calif. L. Rev.* 28 (1950).

2. *Credit for Foreign Death Taxes: Section 2014*

See *supra*, p. 967, for a discussion of this credit.

3. *Credit for Federal Gift Taxes: Section 2012*

Note

Earlier portions of this book have demonstrated how frequently the imposition of a federal gift tax on transfers of property fails to immunize the transferred property against the estate tax. Section 2012 allows the executor a credit against the estate tax in such circumstances, so that "the gift tax amounts in some instances to a security, a form of down-payment on the estate tax which secures the eventual payment of the latter." *Smith* v. *Shaughnessy*, *supra*, p. 1145. The following example (from 4-A P-H Fed. Tax Serv. ¶ 122,812) illustrates the computation of this intricate credit:

Assume the estate of a decedent who died February 15, 1955, is $400,000 after the

payment of debts, administration and other expenses He leaves everything to his wife. On March 1, 1952, he had transferred property worth $100,000 to his wife and paid a gift tax of $4,755 on net gifts of $47,000 ($100,000 minus $3,000 exclusion and $50,000 marital deduction; donor having previously used up his $30,000 specific exemption). The property transferred in 1952 is included in his gross estate as a transfer in contemplation of death at the same value ($100,000), making a gross estate under §2031 of $500,000.

To compute the gift tax credit, first compute the marital deduction, as follows:

Adjusted gross estate (gross estate less expenses)	$500,000
Marital deduction (up to 50% of adjusted gross estate)	250,000

The estate tax is $45,300 ($47,700 — $2,400 credit for state taxes).

The credit may not exceed $8,788.20, computed as follows

$45,300 ($47,700 estate tax reduced by $2,400 credit for state taxes) ×

$48,500 (value of gift taxed property reduced by $3,000 exclusion and proportion of allowable marital deduction to total of property passing to spouse)

—————————————

$250,000 (entire gross estate less total marital deduction)

In this example, the full amount of gift tax paid ($4,755) may be deducted, since it does not exceed the maximum allowable credit of $8,788.20 But if the decedent had paid *more* than the latter amount as a gift tax on the transfer in question, only $8,788.20 would be allowed as a credit. Such a "loss" of his gift tax could occur if the decedent had made substantial taxable gifts before 1952, so that the gift tax on the 1952 transfer in contemplation of death was more than $8,788 20. Another possibility for a "loss" of gift tax arises because the maximum credit is computed by taking the value of the property at the time of the gift or at the time of death, whichever is lower. If the 1952 gift in the example had been worth $200,000 at that time, for example, the decedent's gift tax would have been $14,895. If the property had declined in value to $100,000 at the time of death, apparently only that amount would be includible in the gross estate (*supra*, p 1060), in which event the calculation of the estate tax and of the gift tax credit would be unchanged and only $8,788 20 of the $14,895 actually paid as gift tax could be credited against the estate tax.

Certain other problems and limitations in the computation of this intricate credit, which was modified in a minor way by the 1954 Code, are illustrated by Regs. 105, Sec. 81.7(a) and (c).

Because of the gift tax credit, it may sometimes be profitable to make gifts in contemplation of death deliberately. This is because the gift tax paid will not be included in the gross estate (*i.e.*, the gross estate will comprise only the amount of the gift plus the property owned by the donor after payment of the gift tax), although the gift tax may be credited as a "down payment" on the estate tax, subject to the limitations of §2012.

4. *Credit for Tax on Prior Transfers: Section 2013*

The decedent's estate is allowed to take a credit if the decedent received property from another person (the "transferor") who died within ten years before the decedent's death, provided the transferor's estate was subject to federal estate tax and the transferred property was included in his gross estate. This credit is the descendant of a provision that came into the estate tax law

in 1918, as a result of a recommendation by the House Committe on Ways and Means:

It has come to the attention of the committee that persons closely related have died within such a short space of time that the estate passing within a short period of time has been subjected to the estate tax and thereby diminished unreasonably because of the short period within which the two levies have been made. For example, a husband dies leaving a large amount of property to his wife, an elderly woman, who dies within a few weeks after her husband's death. Under existing law the entire estate is taxed on the transfer from husband to wife and on the transfer from wife to other beneficiaries. (H. Rept. No. 767, 65th Cong, 2d Sess., reprinted in 39-1 C.B. (Part 2) 86, 102.)

To prevent the undue depletion of a family fortune by two estate taxes within a brief period of time, §2013 of the 1954 Code permits the transferee's estate to take a credit for an appropriate portion of the estate tax paid by the transferor's estate. The credit cannot exceed the difference between (a) the estate tax actually imposed on the transferee's estate, and (b) the estate tax that would be due on the transferee's estate if the value of the transferred property were deducted. (The credit is allowed even if the transferee decedent disposed of the transferred property during his life; but this limitation restricts the credit to the amount of estate tax previously paid on the property by the transferor's estate, or to the amount that would be paid by the transferee's estate on property of equal value, whichever is lower.) The credit, computed in accordance with these principles, is allowed in full if the transferor's death occurred within two years before the decedent's death; but it is reduced on a sliding scale if a longer period intervened. §2013(a). No credit is allowed if the transferor died more than ten years before the decedent. The statute allows a similar credit if the transferor dies within two years *after* the death of the transferee. An example is a gift of property by *A* to *B* in 1954, where *B* dies in 1955, and *A* dies in 1957. If the property is included in *A's* estate as a gift in contemplation of death, *B's* estate will be entitled to a credit under §2013(a). (The credit would have to be claimed, in this instance, by an amended return.)

No credit is allowed for any gift tax that may have been paid on property that was transferred to the decedent, no matter how short the interval between the gift and the transferee's death.

Section 2013 is a complete revision, enacted in 1954, of §812(d) of the 1939 Code, which permitted the value of property that had been previously taxed within a five year period to be deducted from the decedent's estate. The deduction was available whether the prior tax was an estate tax or a gift tax, but it was allowed only if the previously taxed property could be "traced" into the decedent's estate. It was not allowed for transfers between husband and wife, and it was subject to many other complex adjustments. The 1954 changes seem to be an amalgam of the proposals made in Rudick, "The Estate Tax Deduction for Property Previously Taxed," 53 *Col. L. Rev.* 761 (1953), and Bittker and Frankel, "Previously Taxed Property and the Federal Estate Tax," 8 *Tax L. Rev.* 263 (1953), which copiously annotate the shortcomings of the pre-1954 law. See Chirelstein and Shieber, "Revision of the Federal Estate and Gift Taxes: The Internal Revenue Act of 1954," 7 *Stan. L. Rev.* 40, 54-62 (1954).

CHAPTER 16

PAYMENT, COLLECTION, AND APPORTIONMENT

Section A. The Estate Tax

1. Payment and Collection

COMMITTEE ON STATE AND FEDERAL TAXATION
AMERICAN BAR ASSOCIATION SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

TRUST RESPONSIBILITIES OF EXECUTORS

Proceedings of Probate and Trust Law Divisions, 1951, pp. 24–28

I. ESTATE NOTICES

The first document which an executor should prepare and file is believed to be unnoticed generally in many parts of the country, even by experienced executors. This is the notice of the assumption of the office of the executor and when properly served upon the Commissioner of Internal Revenue places the executor in the fiduciary relationship insofar as the Commissioner is concerned and continues him in that position until he is properly discharged. No particular form is provided for this notice but the regulations [1] state that it must be in writing, signed by the fiduciary, giving the name and address of the beneficiaries, and be accompanied by certified copies of letters testamentary issued to the executor.

It is generally held that failure to give the notice of appointment in the prescribed form does not relieve the executor of his responsibility to the Federal Government, irrespective of a discharge by the Probate Court.[2] Ordinarily the possibility of a penalty for failure to file such notice would seem to be remote. However it is important to remember that before an assessment is valid, the Commissioner must issue a properly addressed deficiency notice to the taxpayer. The deficiency notice to a decedent is properly addressed if sent to his last known address (Sec. 272(k)) [§6212(b), 1954 Code] unless the executor has given a notice of fiduciary relationship. It is quite possible to envision circumstances of surcharge if a deficiency notice is not duly received by the executor due to his failure to give the proper notice. . . .

Thereafter the executor is required to file a preliminary notice within two

[1] Section 6903; Regs. 111, Sec. 39.312.

[2] Hadley, "Personal Liability: A Bogeyman for the Estate Fiduciary," 28 *Taxes* 133, 136 (1950).

months after the deceased's death or two months after the date the executor qualified as such, whichever of such dates is later.[3] This notice must be filed if the *gross* estate exceeds $60,000 at the date of death. This value is determined under the Federal estate tax statute and has no relevance to the probate estate. Therefore the executor has the duty of examining the affairs of the deceased to ascertain whether or not there are any assets such as life insurance or gifts in contemplation of death, which might raise the gross taxable estate to more than $60,000. This notice must be filed regardless of the deductions of the estate or any contention with respect to the exclusion of such property from the estate. The regulations provide that such notice should be prepared and filed if an examination indicates any doubt of the $60,000 requirement being met and that the filing of such notice is mandatory. . . .[4]

The prescribed Form 704 indicates that an approximation must be given with respect to the various types of property in the estate, but it is understood in many cases that this requirement is ignored and a lump sum is inserted.

It is obvious that ad valorem penalties cannot be asserted on the failure to file this notice because there is no tax by which the penalty could be measured. However Section 894 [§7269, 1954 Code] apparently imposes a mandatory penalty of not exceeding $500 on the person failing to comply with the filing of such returns, together with the cost of the suit to be recovered in a civil action in the name of the United States. Nevertheless it appears to be the general practice that such penalties are not asserted except in a case of a refusal to file such notice after demand. Such penalty necessarily would be imposed directly upon the executor and would not be a charge against the estate.

Apparently this notice is not a "return" within the scope of the criminal penalty provided by Section 894(b)(2)(B) [§7203, 1954 Code] for failure to file a return.

II. Federal Estate Tax Return

The Federal Estate Tax Return (Form 706) must be filed in duplicate within fifteen months from the date of death. [Regs. 105, Sec. 81.63.] Thirty day extensions of time can be obtained from the local *Collector* of Internal Revenue in cases of sickness or absence. [Regs. 105, Sec 81.69.] If the filing of the return is "impossible or impracticable" the *Commissioner* of Internal Revenue may grant an extension of not to exceed six months upon written application showing "good cause." [Regs. 105, Sec. 81.70.] Aside from the usual penalties for failing to file an estate tax return on time, the regulations specifically provide that the failure to file the timely return loses to the estate the privilege of using the optional valuation date. [Regs. 105, Sec. 81.11.]

In preparing the estate tax return one of the most important problems is choosing the appropriate valuation date and sustaining the valuation that is most advantageous to the estate. . . . It is the opinion of many that the failure to select the proper date is justification for surcharging an executor with the loss unless it can be shown that the executor acted with due diligence.

The selection of the optional valuation date has income tax consequences to

[3] Section 6036; Regs. 105, Sec. 81.57 and 81.58.
[4] Regs 105, Sec. 81.57.

the estate. On one hand if the value a year after the date of death is selected there may be no income tax but if the value at the date of death is selected, a sale might result in a loss which is an allowable deduction.[5] Of course in many instances this is an impractical hope in that the Revenue Agent will use hindsight and contend that the value at the date of disposition was the value at the date of death. In valuing property, consideration must be given to the immediate possibilities of sale, *e.g.*, the difference in tax rates between the estate tax rate and the income tax rate, especially if any profit on the sale will be taxed as ordinary income. Another frequent problem is the valuation of notes—the balancing of the probability of payment against receiving some ordinary income if payment is received.

An additional difficult problem is raised by the requirement[6] that certain lifetime gifts be declared in the return even though the executor contends that such transfers are not includible in the taxable estate. A sworn statement "should" be filed giving all material facts and a copy of the death certificate furnished. In many instances it is believed this requirement is virtually ignored until examination of the return and it is the belief of many that only experienced preparation protects an estate from "overdisclosure" in the preparation of the return. A question to be resolved is the ever present conflict between the executor's duty to the estate and his duty to the Federal Government.

III. Payment of Estate Tax

A frequently misunderstood point is that an extension of time for filing the estate tax return is entirely distinct from an extension of time for the payment of tax. The tax must be paid at the end of fifteen months after the date of death unless the Commissioner grants an extension of time on a showing that the payment at the regular time would work an undue hardship upon the estate. [§6161 (a)(2), 1954 Code.] An illustration of this hardship is the disposition of property at a sacrifice in order to raise the money for the payment of the tax. The Commissioner is reluctant to make such extension and usually imposes rigorous conditions before granting it, only passed on by the Washington office of the Bureau. If a timely extension of payment is obtained the unpaid tax shall draw interest at the rate of 4 per cent during the period of extension, commencing 18 months after the date of death. [§6601(b), 1954 Code.] On the other hand, if the extension is not obtained before the due date, the same tax draws interest at 6 per cent from the due date. [§ 6601(a), 1954 Code.] In view of the usual delay for any proceeding in Washington, it is necessary to allow for a considerable lapse of time before the due date occurs. . . .

The statute provides for an extension of time for payment of any estate tax on a reversionary or remainder interest, belonging to the decedent, for six months

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[5] It is frequently overlooked that a low valuation is not desirable in many cases as, for example, in estates where little or no estate tax is to be paid. Bailey & Stoel, "The Executor, The Administrator, and The Tax Collector." 29 *Ore L. Rev.* 76, 101 (1949).

[6] Regs 105, Sec. 81.16. Several interesting questions arise with reference to Schedule G of the Estate Tax Return, *e g.*, what is a "material part" of the decedent's property and when is this to be judged; why are pertinent facts required only as to transfers of "an amount of $5,000 or more"?

after the time such interest vests in possession. However, a bond of double the amount of tax attributable to such interest plus interest at 4 per cent for the estimated duration of the extended period, commencing 18 months after the date of death must be filed. The Commissioner must be advised annually in September of the status of the matter. [§6163(a), 1954 Code; Regs. 105, Sec. 81.79(b).]

IV. Preparing and Filing Income Tax Returns

Generally two or more income tax returns are required to be prepared and filed by the executor.

A. Income to Date of Death

The first one is the last return of the deceased, covering the period between the end of the last taxable period of the decedent and the date of death. The regulations place the duty of filing this return on the executor [Regs. 111, Sec. 39.142-6] . . .

A further income tax problem is raised by the Revenue Act of 1948 which provides for a joint return by the surviving spouse and the executor. [§6013(a)(3), 1954 Code.] Such joint return in most cases will reduce the combined income taxes of the estate and the spouse. However, there is the question of the executor's ascertaining whether the income of the spouse is being correctly reported and whether there might be subsequent developments that would render the joint return injurious to the estate. The Report of the Probate Courts Committee of this Section [Section of Real Property, Probate and Trust Law, A.B.A.] for 1949 suggested the possibility of personal liability to the executor under such circumstances and advises use of an indemnity agreement (a form is provided) and the necessity of collateral. The agreement further provides for the apportionment of refunds, deficiencies and cooperation on procedural steps. Certainly there is substantial peril to the executor if the joint return is for the sole benefit of the surviving spouse.*

In a similar field the executor must consider his assent to a return previously filed. Even though a joint return is filed by a surviving spouse, an executor later appointed may disaffirm within one year after the last day prescribed by law for filing the return of the surviving spouse. The separate return thereafter made by the executor will constitute the return of the deceased spouse for the taxable year. In the absence of specific authority, (some states have special statutes) the present general practice apparently is to judge each case on its merits, *e.g.*, if it is to the advantage of the estate or the risk is not great, the joint return procedure is followed.

B. Income During Probate

. . . An election is given with reference to the deductions described in I.R.C. Sec. 162(e) [§ 642(g), 1954 Code] between taking such items on the income tax return of the estate or on the estate tax return.† Obviously such deduction should be taken where it will yield the most tax benefit. If such deductions are claimed

* See Floyd Estate, *supra*, p. 289. [Ed.]
† *Supra*, p. 1204. [Ed.]

on the income tax return, it is mandatory that a statement be filed therewith, waiving the right to claim the same deduction on the estate tax return. The failure to file such statement loses the income tax deduction even though no estate tax return was required because the gross estate was less than $60,000. The election is an annual one for the expenses of the year concerned.

On the other hand deductions for expenses, interest, taxes and depletion in respect of a decedent allowable under Section 126 [§691, 1954 Code] may be taken on both the income tax return of the estate, if it is otherwise a deductible item by the estate, and as an estate tax deduction, if otherwise allowable on the estate tax return.

C. Executor's Personal Liabilities

In reporting the income of the decedent, it is becoming increasingly obvious that it is the duty of an executor to examine the prior returns of the decedent and to make some reasonable check between the assets in the estate and these returns. A correlation of the two may make it obvious on the usual "net worth" basis * that the decedent had been failing to report part or all of the income from his assets. As has been pointed out by one authority,

> If a careful investigation of all the available evidence, a comparison with returns filed and the questioning of all persons in a position to shed any light on the facts leads the executor to feel reasonably sure that false returns were filed by decedent, it would appear that a clear duty exists to disclose the facts through the preparation and filing of amended returns insofar as it may be possible to prepare such returns. A failure to do so might result in a criminal charge against the executor for the concealment of a material fact in a dealing with an agency of the United States. A violation of Section 145 of the Internal Revenue Code [§§7201-3, 1954 Code] might also be involved.[7]

There is no way that the executor may terminate his responsibilities for the penalties that might be imposed with respect to false returns.

Section 3466 of the Revised Statutes creates a priority in payment in favor of debts to the United States "whenever the estate of a deceased debtor in the hands of the executors or administrators is insufficient to pay all of the debts due from the deceased." Complementary Section 3467 provides for the personal liability of the executor if the injunction of Section 3466 is violated. In the interpretation of these sections of the statutes, the estate tax regulations provide:

> If the executor, before paying all the estate tax, pays, in whole or in part, any debt due by the decedent or the decedent's estate, or distributes any portion of the estate, he is personally liable, to the extent of such payment or distribution, for so much of the estate tax as remains due and unpaid.[8]

The all inclusive language of this regulation would seem to preclude the distribution of any part of the estate by a cautious executor in spite of the fact that a partial distribution may well effect substantial income tax savings.† . . . Section

* *Supra*, pp. 770–83. [Ed.]

[7] Stutsman, "Tax Responsibilities of an Executor," 1950 *So. Calif. Tax Inst.* 551, 564.

[8] Regs. 105, Sec. 81.99.

† In *United States* v. *First Huntington Nat'l Bank*, 34 F. Supp. 576, aff'd. p. c. 117 F.2d 376 (4th Cir. 1941), an action to hold an administrator personally liable under Section 3476 of the Revised Statutes, 31 U.S.C. 192, for an estate tax deficiency, the court refused to entertain the following defense:

"The third defense asserted to this action is that after the assessment was made the defendant

275(b) [§6501(d), 1954 Code] provides that an executor, by due notice, may shorten the period of assessment from three years to eighteen months for the decedent's return and the return filed during the period of administration. Certain exceptions to this short period of assessment are set forth in the Code. The more important of these exceptions are: (1) where twenty-five per cent or more of the gross income has been omitted from the return; (2) where mathematical error has been made in the return, (3) where the return is false or fraudulent; (4) where no return was filed, (5) where transferee liability of the decedent or the estate was involved and was not adequately described in the notice. Hadley raises the question as to whether or not Section 311(c) [§6901(e), 1954 Code] is a further exception.[9]

V. Request for Early Determination of Taxes

In addition to requesting an early determination with respect to income taxes, the executor under Section 825(a) [§2204, 1954 Code] has the right to request the determination of the Federal estate tax within one year from the filing of the return. Thereupon the executor is released from personal liability for any deficiency in estate tax found due after that date.

Many do not realize that such discharge is limited to the *personal liability* of the executor for unpaid Federal estate tax. Such request does not discharge the liability of the estate nor does it release the executor from liability for any other charges asserted under Sections 3466 and 3467. The Section has no applicability to the liability of any person as a transferee of estate assets.

VI. Duty to Obtain Reimbursement for Estate Taxes

Sec. 826(c) [§2206, 1954 Code; *supra*, p. 1165 n] provides that an executor "shall be entitled" to recoup from the beneficiary of any life insurance included in the gross estate such portion of the total estate tax payable as the proceeds of the policies bear to the sum of the net estate and the statutory exemption allowed in computing such net estate. . . . Section 826(d) [§2207, 1954 Code; *supra*, pp. 1185–6] extends a similar authority to recoup proportionately from the object of the power of appointment over which the decedent-donee had a power of appointment. This duty to obtain reimbursement does not extend under either Section to property qualifying for the marital deduction except to the extent that the amount of insurance or property received exceeds the allowable marital deduction. Each section is subject to contrary instructions in the decedent's will.

It is obvious that the expression "shall be entitled" to recoupment is ambiguous. Since this is a matter of state law, some states settle the matter by specific provision

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notified plaintiff that it had distributed all the assets of the estate to the widow of decedent who was then residing in the State of New York, and that with the exercise of reasonable diligence the plaintiff could have collected the deficiency out of assets of the estate in the hands of the widow, or by the enforcement of the liability of the widow as transferee. The defense of laches or equitable estoppel is not available against the United States in a suit by it to enforce a public right or to protect a public interest.... Or, as the rule is sometimes expressed, the laches of its officers or agents will not be imputed to the government." [Ed.]

[9] *Supra*, note 2, 133.

in their statutes.* In the absence of an agreement among all parties in interest that the estate itself shall discharge the entire tax burden, in the states having no such statutes it seems that a prudent executor would file suit, if necessary, against any such person to discharge the duty of the executor to conserve the estate. Otherwise there would be grounds for objection by the beneficiaries of the estate with the possibility of surcharging the executor.

VII. Duty to File Gift Tax Return

Section 1026 [see §6903, 1954 Code] enjoins the executor to file gift tax returns—either donor or donee—for the decedent. Assuming research reveals no delinquent returns for the past, there arises a problem similar to the one discussed heretofore as to a joint income tax return with the surviving spouse.

The 1948 Revenue Act authorized the executor to consent to gifts of the surviving spouse and vice versa. [§2513, 1954 Code.] If the executor consents, the benefit to the estate apparently is non-existent and the executor must seek adequate protection. If the decedent made the gift, an obvious duty falls on the executor to seek immediately the consent of the surviving spouse.

VIII. Distribution of Income

There is the responsibility for tax planning which may not be such a duty as to incur a surcharge upon the executor, but it is the type of responsibility that is implicit in the proper execution of fiduciary duties. It is becoming increasingly obvious that in substantial estates or where the beneficiaries of the estates already have substantial income, the executor annually ought to assemble the facts and figures that will reveal the probable net income of the estate before the end of the year, and then consult the beneficiaries of the estate so as to coordinate distributions from the estate in a manner that will minimize the income tax liabilities of all.[10] Implicit in such undertaking will be the necessity of deciding as soon as the executor is appointed the question of how soon any testamentary trusts can be set up, the interpretation of any provisions of the will, and whether or not there are sufficient assets to avoid any personal liability to the executor making such distributions.[11]

The matter has been summarized by Armstrong [12] as follows:

> The executor will engage in a multiphase calculation having the object of estimating or determining the amount of administration expense to be paid in the first year and deduct it for income (as distinguished from estate) tax purposes; the amount of income to be distributed and taxed to heirs and legatees and the amount that will remain for taxation to the estate; the effect of the presence of a testamentary trust (if there is one), particularly a trust where the fiduciary has the discretion either to retain or to distribute income with the result of retaining or shifting the tax burden as between the trust and beneficiaries, the desirability of filing a joint return for the decedent and a

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* *Infra*, p. 1244 [Ed.]

[10] It has frequently been pointed out that if it is desirable to use the administration expenses as an income tax deduction, the payment of such expenses must be planned so that there remains income taxable to the estate in the year of payment of such expenses.

[11] See generally Brown, "Distribution of Estate Income," 1950 *So. Calif. Tax Inst.* 537.

[12] Armstrong, "Tax Planning for Distributions," 90 *Trusts and Estates* 378 (1951).

surviving spouse (if there is one). The objective is, of course, to get losses and expense deductions into the year and return where they will do the most good, and to spread the income around among the estate, the testamentary trust, the surviving spouse and the heirs or legatees in such a fashion that the respective taxable incomes of all are brought as nearly as possible to a common level.

Generally speaking the exact measure of the liability of the executor for the failure to discharge the duties discussed herein has not been clarified by the courts. "But it is difficult to conceive of a court being sympathetic toward an executor, particularly one who makes such his profession, who failed to avail himself of every opportunity to minimize the tax burden of the estate and therefore of the beneficiaries who receive it." [13]

Note

1. See also Paul, *Federal Estate and Gift Taxation* (1942 and 1946 Supp.), Ch. 13; Greenbaum, "What Is the Personal Responsibility and Liability of the Fiduciary for Payment of Taxes?" *10th Ann. N.Y.U. Inst. on Fed. Taxation* 881 (1952). For the procedures of the Internal Revenue Service in collecting estate and gift taxes, examining returns, making refunds, *etc.*, see *Code of Federal Regulations,* Title 26, Part 601.27–.33; Harriss, "Federal Estate Tax Administration," 28 *Taxes* 341 (1950); Harriss, "Wealth Estimates As Affected by Audit of Estate Tax Returns," 2 *Nat'l Tax J.* 316 (1949).

2. On the income tax problems of estates, see Michaelson, *Income Taxation of Estates and Trusts* (P.L.I., 1955), Stern, "The Income Tax Problems of Estates," *13th Ann. N.Y.U. Inst. on Fed. Taxation* 147 (1955); Baker, "Income Tax Planning for Executors," 9 *Tax L. Rev.* 281 (1954). Because the estate is a separate taxpayer, an accumulation of income by the executor during the period of administration may effect a savings in income taxes for the beneficiary. But the period of administration may not last forever. Regs. 118, Sec. 39.162–1(g); *Estate of Hargis* v. *Commissioner,* 19 T.C. 842 (1953). Is it possible that litigation by the executor over the federal estate tax liability will justify a continuance of administration that will in turn produce a savings in income taxes in excess of the costs of litigation? Stern, *supra,* at 157.

EQUITABLE TRUST COMPANY v. COMMISSIONER

Tax Court of the U.S. 1949
13 T.C. 731

HARLAN, Judge.

Respondent contends that petitioner is personally liable for the tax in question under the express provisions of section 827(b) of the [1939] Internal Revenue Code [§6324(a)(2), 1954 Code].[1] Petitioner contends that liability under that section does not attach to a trustee of property transferred in trust prior to death unless and until the Commissioner has pursued and exhausted his remedies against the executor.

The solution of this controversy rests upon an examination of section 827(b) in

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[13] Stutsman, *supra* note 7, at 571.

[1] SEC. 827. LIEN FOR TAX.

(b) LIABILITY OF TRANSFEREE, ETC.—If the tax herein imposed is not paid when due, then the spouse, transferee, trustee, surviving tenant, person in possession of the property by reason of the exercise, non-exercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 811(b),(c),(d),(e),(f), or (g), to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. . . .

the light of its affiliated sections and of its wording. Section 822(b) [§2002, 1954 Code] provides that tax imposed by this subchapter shall be paid by the executor to the collector. Then follow a number of sections setting forth the remedies available to the Commissioner in the event the executor does not pay the tax as directed. Section 826(a) [§7404, 1954 Code] [2] provides that if the executor fails to pay estate tax when due the collector shall "proceed to collect the tax under the provisions of general law" or by judicial proceedings the Commissioner may subject the assets of the estate to sales under judgment or decree of the court. Section 827(a) provides that, if the tax is not paid by the executor, the assets of the estate shall be subject to a lien for unpaid taxes for a period of ten years.

Finally, section 827(b) [§6324(a)(2), 1954 Code] provides that, if the executor fails to pay the tax when due, then the Commissioner may proceed personally against "the spouse, transferee, trustee, surviving tenant," appointee, appointor, or beneficiary, "who receives, or has on the date of the decedent's death, property included in the gross estate under section 811(b),(c),(d),(e),(f), or (g), to the extent of the value, at the time of decedent's death, of such property." Section 827(b) became law as section 411 of the Revenue Act of 1942. That act also defined the word "transferee" as used in section 827(b) to include heir, legatee, devisee, and distributee. In none of the above sections is the power of the Commissioner to proceed in any way affected by the *cause* of the failure of the executor to pay the tax when due. None of the sections say that the Commissioner may proceed against the transferred assets, or personally against the various transferees thereof, only when the executor is unable to pay. The only statutory requirement authorizing action by the Commissioner is for the tax not to be paid when due by the executor.

The petitioner argues that the statement in section 826(b) [§2205, 1954 Code],[3] that it is "the purpose and intent of this subchapter that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution," requires the Commissioner "to secure the payment of the tax out of the estate before its distribution." We are unable to perceive that this section imposes any obligation upon the Commissioner whatsoever. It covers a situation where, if one of the recipients of the assets of the estate pays the estate tax, he may either collect it from the undistributed assets in the hands of

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[2] Sec. 826. Collection of Unpaid Tax.

(a) Sale of Property.—If the tax herein imposed is not paid on or before the due date thereof the collector shall, upon instruction from the Commissioner, proceed to collect the tax under the provisions of general law; or appropriate proceedings may be commenced in any court of the United States having jurisdiction, in the name of the United States, to subject the property of the decedent to be sold under the judgment or decree of the court. . . .

[3] Sec 826. Collection of Unpaid Tax.

(b) Reimbursement Out of Estate.—If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this subchapter that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution.

the executor or enforce contributions from the other recipients in proportion to their receipts. Section 826(b) is obviously designed to permit "any person other than the executor," be he or she spouse, transferee, heir, legatee, devisee, distributee, trustee, surviving tenant, appointee, or beneficiary, who pays more than his or her share of the estate tax, to enforce contributions from the other recipients of the assets of the estate, or to proceed against the assets remaining in the hands of the executor for recompense. Such a provision is equitable and necessary because, under sections 826(a), 827(a), 827(b), and 827(c), the Commissioner is given broad and unhampered powers to proceed to collect the tax under the provisions of general law, subject the assets to a ten-year lien, or to obtain personal judgments against those who have received assets from the estate on which the estate tax has not been paid. If the Commissioner were required first to exhaust his remedies against the assets in the hands of the executor before proceeding against the recipients personally, then the provisions of section 826(b) which authorize such recipients who are forced to pay the tax to procure "reimbursement out of any part of the estate still undistributed" would be nonsense, because there would be no such undistributed assets. The clear implication of section 826(b) therefore is that, when the Commissioner forces the transferee to pay the estate tax, there may well be assets in the hands of the executor against which the transferee may proceed. It is to be noted that this section refers to "any person other than the executor" and does not, therefore, exclude transferees.

Therefore, it appears to us that, instead of section 826(b) supporting petitioner's inference that the Commissioner is obligated to exhaust the assets of the estate before collecting against the transferees, said section, when considered with its cognate sections, actually supports an inference that the Commissioner is authorized to collect the tax from any person he finds presently in possession of untaxed estate assets or from any person who has received and has disposed of such assets, and he is not hampered by the equitable rules ordinarily inherent in imposing transferee liability.

Petitioner herein relies upon *Florence McCall*, 26 B T.A. 292; and *Alex Harjo*, 34 B.T.A. 467. In both of these cases the Commissioner sought to collect an estate tax from a transferee without showing that the executor had no estate assets and was personally insolvent. In both cases the Court *assumed* without apparent argument from the Commissioner that the transferees of said assets under the statutes then in force were not subject to liability until all efforts to collect from the executor had proved futile.

It is not necessary at this time to discuss this assumption. The decisions were based upon section 316 of the Revenue Act of 1926, which was the predecessor of section 900 [§6901, 1954 Code], which is confined to delineating the liabilities of transferees In the two cited cases the opinions contain no discussion of sections 314 and 315 of the Revenue Act of 1926, which were the predecessors of the sections of the code relied upon by the Commissioner herein. In short, in the cited cases the whole question of law that is now before this Court was not then considered.

In *Evelyn N. Moore*, 1 T.C. 14; affd., 146 Fed.2d 824, the taxpayer's husband made gifts to the taxpayer in 1935 and paid a gift tax thereon. The Commissioner subsequently determined that gifts made by the husband in years prior to 1935 had

subjected the 1935 gifts to a higher tax rate than was reported and paid. Thereupon a deficiency was determined and, without proceeding against the donor or showing him to be insolvent, a notice was served on the taxpayer donee. In that case the Court said·

> The petitioner points out that the donor was at all times solvent and able to pay all that was due from him, but the Commissioner failed to pursue his remedies against the donor within the time allowed by the statute. She, therefore, contends that there is no basis for holding her liable as a transferee. . . . This argument is based upon the erroneous assumption that the transferee liability which the Commissioner is asserting is based upon some equitable ground, sometimes described as the "trust fund" theory of transferee liability. But the Commissioner does not rely upon any equitable principles to show that this petitioner is liable as a transferee. Instead, he relies upon the following express statutory provision which is found in section 510 of the Revenue Act of 1932.
>
> Lien for Tax
>
> The tax imposed by this title shall be a lien upon all gifts made during the calendar year, for ten years from the time the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.
>
> The above provision does not require, as a condition precedent to personal liability on the part of the donee, that the Commissioner first pursue his remedy against the donor, or that the gift itself render the donor insolvent and unable to pay the tax.

Petitioner in its brief attempts to distinguish the *Moore* case from the one at bar because "there is no provision in the gift tax provisions, as there is in the estate tax, to the effect that payment of the tax so far as practicable and unless otherwise directed by the transferor shall be paid by the latter out of his estate before its distribution."

As we have pointed out above, the provisions of section 826(b) to which petitioner's brief alludes impose no more obligation on the Commissioner in collecting from the transferee in estate tax cases than in those cases involving gift taxes. Section 510 of the Revenue Act of 1932 (pertinently quoted in *Evelyn N. Moore, supra*), now section 1009 [§6324(b), 1954 Code], in its essential provisions is substantially identical with section 827(a) and (b), which is before us. Adopting the reasoning of the *Moore* case, we conclude that the Commissioner did not err in determining the deficiency herein.

Reviewed by the Court.

Decision will be entered for the respondent.

Van Fossan, J., dissenting: It is my judgment that this case is not distinguishable from *Florence McCall*, 26 BTA. 292, and other cases decided by this Court. Certain I am that in the *McCall* case we did not "assume" without argument "that the transferees of said assets under the statutes then in force were not subject to liability until all efforts to collect from the executor had proved futile." That holding was basic in the cited case and was buttressed with ample and well recognized authority. The slight variation in the language of the present statute from that then in force is not sufficient to justify a departure from the rule there laid down. Nor can I agree that "in the cited cases the whole question of law that is now before this Court was not then considered," as stated in the prevailing opinion.

Being of the opinion that the holding of the majority is at once faulty in its logic and contrary to well settled law, I dissent.

Opper, J., agrees with this dissent.

Note

May any of the tax be collected from an insurance company that is holding the proceeds of a policy in accordance with the decedent's instructions to pay in instalments to the beneficiaries? *John Hancock Mutual Life Insurance Co.* v. *Helvering*, 128 F.2d 745 (D.C. Cir. 1942), *Equitable Life Assurance Society* v. *Commissioner*, 19 T.C. 264 (1952).

2. *Apportionment of the Estate Tax*

Note

Unless the decedent or a statute provides to the contrary, the burden of the federal estate tax, like the burden of administrative expenses, debts and other charges, ordinarily falls upon the residuary estate. See *In re Hamlin*, 226 N.Y. 407, 124 N.E.4 (1919), *cert. den*, 250 U.S. 672. If the residue is insufficient, specific legacies and other interests will be abated in the same manner as when debts exceed the residue. Contrariwise, inheritance taxes, which are levied on the recipients of the estate, usually come out of the recipients' shares; thus, residuary legatees are burdened only with the inheritance tax pertinent to their own shares.

Although testators have always been able to direct the estate tax to be apportioned among all or particular legatees,* proper clauses are often omitted, even where the decedent might well have preferred apportionment. This fact led the New York State Commission to Investigate Defects in the Laws of Estate to recommend the enactment of a state statute to apportion the burden of the tax:

> The great complaint against the estate tax has been that this burden falls upon the residuary legatees, who are, under most wills, the widow, children, or nearer or more dependent relatives. Cases have arisen where the residue has been greatly depleted by the imposition of the Federal Estate tax. Moreover, the residuary legatee under the present system is compelled not only to pay the tax assessed against the transfers passing by operation of the will, but is also compelled to pay the tax on other transfers to persons not participating in the decedent's estate. Thus, if a gift in contemplation of death has been made, or a transfer under an *inter vivos* trust becomes effective by reason of the death of the settlor, the tax on all such transfers is imposed upon the residuary legatees. This new law provides for an equitable apportionment of all these transfers by the surrogate in an accounting or other appropriate proceeding on notice to all the parties. Thus the donee of a gift taking effect at death will be compelled to bear his fair share of the tax upon the amount of the property which he derived and which was included in the general estate subjected to taxation. It is believed that this plan will present a fair, just and equitable method of the allocation of the estate tax, both Federal and State [Legis Doc. No 69, 1930, pp. 197–198.]

The hardship is accentuated when there is an unexpected fall in the value of the estate's assets, or where the taxable estate is swollen by the inclusion of *inter vivos* gifts, insurance proceeds, and property subject to powers of appointment. See generally, Sutter, "Apportionment of the Federal Estate Tax in the Absence of Statute or an Expression of Intention," 51 *Mich. L. Rev.* 53 (1952).

Sensitive to this problem, a few states have provided for apportionment of *state* death taxes in the absence of contrary instructions in the will. And, as noted *supra*, pp. 1165n and 1185–6, the Internal Revenue Code provides that the beneficiaries of life insurance and powers of appointment shall pay their fair share of the federal

* Congress could presumably provide a comprehensive system of apportionment, as an incident of its power to tax, but it has not done so. See Note, 62 *Harv. L Rev.* 1022, 1024 (1949).

estate tax. Because of this limited federal scheme of tax apportionment, doubts long existed whether a state could properly provide a comprehensive method of apportioning both state and federal taxes.

RIGGS v. DEL DRAGO

Supreme Court of the United States, 1942
317 U.S. 95

MR. JUSTICE MURPHY, delivered the opinion of the Court.

The question for decision is whether §124 of the New York Decedent Estate Law, which provides in effect that, except as otherwise directed by the decedent's will, the burden of any federal death taxes paid by the executor or administrator shall be spread proportionately among the distributees or beneficiaries of the estate, is unconstitutional because in conflict with the federal estate tax law.

Testatrix, a resident of New York, died on October 8, 1937, leaving a will dated March 27, 1934, which, after certain gifts of personal effects and small sums of cash, bequeathed $300,000 outright to respondent Giovanni del Drago and created a trust of $200,000 for the benefit of respondent Marcel del Drago during his life, with remainder over upon his death. The residue of testatrix's estate was left in trust for the benefit of Giovanni during his life, with remainder over upon his death. The will contained no reference to the payment of estate or inheritance taxes.

The executors paid approximately $230,000 on account of the federal estate tax and then asked the Surrogate, in a petition for the settlement of their account, to determine whether that payment should be equitably apportioned among all the persons beneficially interested in the estate pursuant to §124 of the Decedent Estate Law. Giovanni and Marcel del Drago answered, raising objections to the constitutionality of §124. Petitioner, who was appointed special guardian to represent the interests of the infant remaindermen under the residuary trust, urged that the tax be apportioned. The Surrogate overruled the constitutional objections and directed apportionment. The New York Court of Appeals by a divided court reversed, holding §124 repugnant to the federal estate tax law—particularly to §826(b) [§2205, 1954 Code]—and in violation of the supremacy (Art. VI, cl. 2) and the uniformity (Art. I, Sec. 8, cl. 1) clauses of the Constitution. The importance of the question moved us to grant certiorari.

We are of opinion that Congress intended that the federal estate tax should be paid out of the estate as a whole and that the applicable state law as to the devolution of property at death should govern the distribution of the remainder and the ultimate impact of the federal tax; accordingly, §124 is not in conflict with the federal estate tax law. This conclusion is based upon the provisions of the Revenue Act of 1916, 39 Stat. 756, and subsequent acts, their legislative history and their administrative interpretation.

In the Act of 1916 Congress turned from the previous century's inheritance tax upon the receipt of property by survivors (see *Knowlton* v. *Moore*, 178 U.S. 41; *Scholey* v. *Rew*, 23 Wall. 331) to an estate tax upon the transmission of a statutory "net estate" by a decedent. That act directed payment by the executor

in the first instance, §207, but provided also for payment in the event that he failed to pay, §208. It did not undertake in any manner to specify who was to bear the burden of the tax. Its legislative history indicates clearly that Congress did not contemplate that the Government would be interested in the distribution of the estate after the tax was paid, and that Congress intended that state law should determine the ultimate thrust of the tax.[1] That Congress from 1916 onward has understood local law as governing the distribution of the estate after payment of the tax (with the limited exceptions created by §826(c) and (d) of the [1939] Code, to be discussed presently) is confirmed by §812(d) [§2055(c), 1954 Code; *supra*, pp. 1215–6], dealing with charitable deductions, which recognizes that estate taxes may be payable in whole or in part out of certain bequests, *etc.* "by the law of the jurisdiction under which the estate is administered." The administrative interpretation has been in accord,[2] and that has been the understanding of the federal courts, and of some state courts.

In reaching a contrary result, the court below relied primarily upon §826(b) [§2205, 1954 Code].[3] But that section does not direct how the estate is to be distributed, nor does it determine who shall bear the ultimate burden of the tax. As pointed out before, while the federal statute normally contemplates payment of the tax before the estate is distributed, §822(b) [§2002, 1954 Code], provision is made for collection of the tax if distribution should precede payment. §826(a) [§7404, 1954 Code]. If any distributee is thus called upon to pay the tax, §826(b) [§2205, 1954 Code] provides that such person "shall be entitled to reimbursement

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1 Congressman Cordell Hull, one of the supporters of the 1916 Act and its reputed draftsman, declared· "Under the general laws of descent the proposed estate tax would be first taken out of the net estate before distribution, and distribution made under the same rule that would otherwise govern it Where the decedent makes a will he can allow the estate tax to fasten on his net estate in the same manner, or if he objects to this equitable method of imposing it upon the entire net estate before distribution he can insert a residuary clause or other provision in his will, the effect of which would more or less change the incidence of the tax." 53 Cong. Rec. 10657.

Congressman Kitchin, Chairman of the House Ways and Means Committee, stated: "We levy an entirely different system of inheritance tax. We levy the tax on the transfer of the flat or whole net estate. We do not follow the beneficiaries and see how much this one gets and that one gets, and what rate should be levied on lineal and what on collateral relations, but we simply levy on the net estate This also prevents the Federal Government, through the Treasury Department, going into the courts contesting and construing wills and statutes of distribution." 53 Cong. Rec. app. p. 1942.

2 The Treasury has taken the position, at least since 1922, that it has no interest in the distribution of the burden of the estate tax See Article 85 of Regulations 63, Article 87 of Regulations 68, Regulations 70 (1926 and 1929 eds.), and Regulations 80 (1934 and 1937 eds.); and, Section 81 84 of Regulations 105.

3 This section was originally enacted as part of §208 of the Act of 1916 Its full text is as follows.

"§826. Collection of unpaid tax . .

"(b) Reimbursement out of estate. If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this subchapter that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution."

out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate." By that section Congress intended to protect a distributee against bearing a greater burden of the tax than he would have sustained had the tax been carved out of the estate prior to distribution; any doubt that this is the proper construction is removed by the concluding clause of the section specifically stating that it is "the purpose and intent of this subchapter that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution." Section 826(b) does not command that the tax is a nontransferable charge on the residuary estate; to read the phrase "the tax shall be paid out of the estate" as meaning "the tax shall be paid out of the *residuary* estate" is to distort the plain language of the section and to create an obvious fallacy. For in some estates there may be no residue or else one too small to satisfy the tax; resort must then be had to state law to determine whether personalty or realty, or general, demonstrative or special legacies abate first. In short, §826(b), especially when cast in the background of Congressional intent discussed before, simply provides that, if the tax must be collected after distribution, the final impact of the tax shall be the same as though it had first been taken out of the estate before distribution, thus leaving to state law the determination of where that final impact shall be.

Respondents also rely on §826(c) [§2206, 1954 Code], authorizing the executor to collect the proportionate share of the tax from the beneficiary of life insurance includible in the gross estate, and §826(d) [§2207, 1954 Code], authorizing similar action against a person receiving property subject to a power [of appointment], as forbidding further apportionment by force of state law against other distributees.[4] But these sections deal with property which does not pass through the executor's hands and the Congressional direction with regard to such property is wholly compatible with the intent to leave the determination of the burden of the estate tax to state law as to properties actually handled as part of the estate by the executor.

Since §124 of the New York Decedent Estate Law is not in conflict with the federal estate tax statute, it does not contravene the supremacy clause of the Constitution. Nor does the fact that the ultimate incidence of the federal estate tax is governed by state law violate the requirement of geographical uniformity. *Cf. Phillips* v. *Commissioner,* 283 U.S. 589, 602.

The judgment is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

Reversed.

Note

1. Following this decision, many states enacted apportionment statutes patterned to a greater or lesser extent on the New York law. See Fleming, "Apportionment of Federal Estate Taxes," 43 *Ill. L. Rev.* 153 (1948); Kaich, "The Apportionment of Death

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[4] This argument was accepted in *Bemis* v. *Converse,* 246 Mass. 131, 140 N.E 686, and *Farmers' Loan & Trust Co.* v. *Winthrop,* 238 N.Y. 488, 144 N.E. 769.

Taxes," 54 *Harv L. Rev.* 10 (1940); Mitnick, "State Legislative Apportionment of the Federal Estate Tax," 10 *Md. L. Rev.* 289 (1949); Saiber & Widmark, "Estate Taxes and the New Jersey Apportionment Act," 73 *N.J.L.J.* 319 (1950); Note, "The Apportionment of the Federal Estate Tax in Pennsylvania," 54 *Dick. L. Rev.* 432 (1950); Note, "Statutory Apportionment of Federal Estate Taxes," 62 *Harv L. Rev.* 1022 (1949).

Note the reference in *Riggs* v. *Del Drago* to a Congressional "intent to leave the determination of the burden of the estate tax to state law as to properties actually handled as part of the estate by the executor" Does this mean that states may not apportion as against non-probate property? What if the state apportionment formula would impose a heavier—or a lighter—burden on life insurance beneficiaries and recipients of property subject to powers of appointment than is imposed by §§2206 and 2207 of the 1954 Code?

2. Special problems arise when some of the interested parties are outside the apportioning state or when the gross estate includes property, such as an *inter vivos* trust, administered elsewhere. See *In re Gato's Estate,* 276 App. Div. 651, 97 N.Y.S.2d 171 (1st Dep't 1950) (trustee of New York *inter vivos* trusts included in gross estate of Florida decedent ordered to contribute to payment of estate tax on basis of Florida apportionment statute); see also, Schiaroli, "Apportionment of Federal and State Estate Taxes in Connecticut," 20 *Conn. B.J.* 198, 209–15 (1946). For a discussion of the conflicts questions arising when the decedent's estate is found in several states, see Scoles, "Apportionment of Federal Estate Taxes and Conflict of Laws," 55 *Col. L. Rev.* 261 (1955)

3. Even without statutory authority, some state courts have come recently to apply a doctrine of equitable apportionment to relieve the residuary legatees of the tax caused by *inter vivos* transfers and other non-probate property. *E.g., Regents of the University System* v. *Trust Co. of Ga.,* 194 Ga. 255, 21 S.E.2d 691 (1942); see Note, "Equitable Apportionment of Federal Estate Tax on Non-Probate Property," [1955] *Wash. U. L. Q.* 89; Note, "Proposal for Apportionment of the Federal Estate Tax, 30 *Ind. L. J.* 217 (1955), suggesting the need of a federal apportionment statute.

MARKS. v. EQUITABLE LIFE ASSURANCE SOC. OF UNITED STATES

Court of Chancery of New Jersey, 1944
135 N.J. Eq. 339, 38 A.2d 833

SOOY, Vice Chancellor.

This matter comes before me for final hearing on a bill filed by the executors and trustees of the estate of Morris Dannenbaum, late of the City of Atlantic City, against The Equitable Life Assurance Society of the United States, The Mutual Life Insurance Company of New York, New England Mutual Life Insurance Company, New York Life Insurance Company, Northwestern Mutual Life Insurance Company and The Penn Mutual Life Insurance Company, hereinafter referred to as the insurance companies.

Complainant, who is the sole surviving executrix and trustee under her father's will, has remarried since the filing of the bill and her name is now Rosalie D. Denzer.

The defendant insurance companies have on deposit approximately $300,000 which constitute the proceeds of life insurance policies issued on the life of said Dannenbaum. This $300,000 is held pursuant to the terms of settlement agreements selected by said Morris Dannenbaum during his lifetime. The policies do not

designate specific beneficiaries to whom the proceeds were to be paid, but instead contain settlement agreements directing that the proceeds should be held by the companies and paid in the following manner:

1. Interest at a fixed rate to be paid annually to Mrs. Denzer for the term of her natural life, plus in the case of the mutual companies any additional interest allotted by the companies based on their general earnings.

2. Mrs. Denzer is granted the privilege of withdrawing $6,000 annually ($1,000 a year from each company) during her natural life.

3. On the death of Mrs. Denzer interest at a fixed rate plus in the case of the mutual companies any additional interest allotted by reason of excess general earnings of the companies to Alan and Sheila Marks, children of Mrs. Denzer, for the term of their natural lives, survivor of one to take other's interest if first to die leaves no issue.

4. Remaining principal to issue of Alan and Sheila Marks.

5. If no issue of Alan and Sheila Marks, remaining principal to be added to the corpus of an insurance trust established by Morris Dannenbaum in 1934. This insurance trust provides for the receipt by the trustee of the proceeds of certain policies (not those involved herein) taken out by Morris Dannenbaum on his life and on which he paid the premiums and the transfer of those proceeds to the Federation of Jewish Charities. The trust deed contains a provision that the Jewish Hospital, Philadelphia, and Mt. Sinai Hospital, Philadelphia, be substituted and take equal shares if the Federation of Jewish Charities is not in existence at the time payments are to be made. The trust deed has a further provision that any charity may be substituted in the discretion of the trustee if none of the named charities is in existence at the time payments are to be made.

Testator's estate was a very substantial one and was, generally speaking, disposed of by him principally in trust, the trust res consisting of the residuary estate from which testator provided for an annuity to his son for life and gave to his daughter, complainant herein, the income on the balance of the residuary estate for life and upon her death her children are to take the income for life and on the termination of the trust the principal goes to certain charities.

The executrix paid Federal and New Jersey estate taxes in a total sum of $132,279.44. The amount paid for Federal and State estate tax by reason of the inclusion of the life insurance proceeds in the gross estate was $45,358.61; the amount paid to the State of New Jersey under its estate tax was $3,848.13 and the amount paid to the Federal Government was $41,510.48.

The prayer for relief is of a fourfold nature, (a) construction of the will of the decedent, (b) instructions to the executrix based upon such construction, (c) for an accounting and (d) that a decree be made against the six insurance company defendants requiring them to proportionately reimburse the executrix for the amount of Federal and State taxes paid by said executrix by reason of the proceeds of the life insurance policies having been included in the gross estate of decedent.

The relief sought is against the six insurance companies only, based on the allegations of paragraph 11 of the bill of complaint, as follows:

"Complainants contend that by virtue of the Federal Statute in such case made and provided [§2206, 1954 Code], and by virtue of the fact that decedent impliedly

directed the insurance companies aforesaid to reimburse his executors, which implied direction is contained in paragraph 10 of decedent's will, a copy of which is hereunto annexed, marked exhibit A, the said" six life insurance companies "are respectively required to reimburse complainants in the proportions mentioned in the bill of complaint."

The question to which an answer is sought is that stated in the 13th paragraph of the bill of complaint, as follows:

> Are the said six life insurance companies (naming them) liable to complainants for the payment to them of the proportionate amount of the Federal and estate tax and the New Jersey estate tax, together with interest from August 2, 1940 assessed on account of the inclusion in decedent's gross estate of the proceeds of the insurance policies referred to in this bill?

From the foregoing it is evident that the prayer for an accounting is merely incidental to the real relief which complainant seeks. In other words, there is no real necessity for an accounting because if the insurance companies are liable as suggested by complainant the respective amounts of their liability would be mathematically ascertained without the necessity of an accounting.

Jurisdictional questions are raised by the insurance companies which, in view of the result herein reached, will not be passed upon excepting as that result necessarily passes upon the question as to whether, under the circumstances of this particular case, the Court has jurisdiction to enter the decree asked for against the defendant insurance companies.

In order to answer the question as propounded by complainant as above set forth it is necessary to have before us the provisions of the 10th clause of the will aforesaid, as well as the provisions of the Federal Statute hereafter quoted. Paragraph 10 of the will reads as follows:

> Tenth. I direct all inheritance, succession or legacy taxes of any sort on the legacies bequeathed by my Will, including also such taxes on life interest in the trust estates herein created, and including my residuary estate, shall be borne by the principal of said residuary estate, so that all legatees and beneficiaries shall receive the interests bequeathed to them free and clear of all such taxes.

The cases construing like sections of the will are found in *Gaede* v. *Carroll*, 114 N.J.Eq. 524, 169 A. 172; *Fidelity Union Trust Co.* v. *Suydam*, 125 N.J.Eq. 458, 6 A.2d 392; *Morristown Trust Co.* v. *Childs*, 128 N.J.Eq. 524, 17 A.2d 559.

In the foregoing cases provisions as to the payment of Federal and State taxes very similar to the section 10 now under consideration were construed, with a uniform holding that results in my concluding that the monies accruing at the death of the testator under the life insurance policies did not pass "by my will" and that testator did not, therefore, direct that the Federal and State taxes be "borne by the principal of said residuary estate, . . . free and clear of all such taxes," and that this being so, the implied direction of the testator was that "such taxes" be paid as directed by the statute in such case made and provided. That statute [§826(c), 1939 Code] reads as follows:

> Liability of life insurance beneficiaries. If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies

bear to the net estate. If there is more than one such beneficiary the executor shall be entitled to recover from such beneficiaries in the same ratio.*

A decree such as complainants seek from the defendant insurance companies, requiring them to pay the Federal and State taxes would require a finding that these insurance companies are "beneficiaries" of the proceeds of the policies, and complainants contend that they are such beneficiaries as were contemplated by the statute.

It is conceded by complainants that the relationship between the insurance companies and the beneficiaries named in the policies is that of debtor and creditor. . . .

Notwithstanding the debtor and creditor relationship, complainants contend that the insurance companies should now pay Federal and State taxes, even though at this time, under the insurance contracts, the companies are not liable for such payments and even though under the contracts of insurance the companies only agreed to pay stipulated sums at certain times to the beneficiaries named in the policies. Complainants' reasoning is that the insurance companies, as recipients of the proceeds of the policies, are "beneficiaries," as contemplated by the statute. I find no supporting cases in New Jersey nor does counsel supply any. However, reliance is placed on *In re Scott's Estate*, 158 Misc. 481, 286 N.Y.S. 138, affirmed 249 App. Div. 542, affirmed without opinion 274 N.Y. 538, 10 N.E.2d 538, certiorari denied sub nom. *Northwestern Mutual Life Ins. Co.* v. *Central Hanover Bank & Trust Co.*, 302 U.S. 721. The *Scott* case involved a proceeding brought before the Surrogate of New York County under Sec. 124 of the N. Y. Decedent Estate Law, which provides in part as follows:

> In all cases in which any property required to be included in the gross estate does not come in the possession of the executor as such, he shall be entitled, and it shall be his duty, to recover from whomever is in possession, or from the persons interested in the estate, the proportionate amount of such tax payable by the persons interested in the estate with which such persons interested in the estate are chargeable . . . and the surrogate may by order direct the payment of such amount of tax by such persons to the executor.

The executor, a New York trust company, had paid the New York and Federal taxes out of the general assets. These taxes were paid upon a valuation which included life insurance policies. The proceeds of all policies were payable under supplemental agreements to named beneficiaries. The executor obtained from the Surrogate in a proceeding to which the insurance companies and all the beneficiaries were parties, an order directing the insurance companies to reimburse it for pro rata portions of the taxes so paid, based upon the ratio of taxable life insurance to the taxable estate of the decedent. The judgment of the Surrogate was appealed to the Appellate Division, and sustained, but two Judges dissented, joining in a strong minority opinion. In the Court of Appeals, no opinion was written, and two Judges likewise dissented.

By the terms of the statute under which the *Scott* case was brought, reimbursement of the tax could only be had by the executor "from whomever is in possession, or from the persons interested in the estate." In the opinion of the

* See §2206, 1954 Code, which is substantially the same except for changes to reflect the 1942 elimination of the special $40,000 exemption for life insurance, *supra*, p. 1166, and the 1948 enactment of the marital deduction. [Ed.]

Surrogate, the right of the executor to reimbursement was based upon the argument that the power of the Government to tax insurance funds and to collect such tax could not be limited or impaired by the provisions of an insurance policy; but "parties cannot by form of contract undertake to defeat the power of the state to tax transfers and to impose death duties. Contracts effective at death and creating or transferring property rights at death must be deemed to have written into them a term which preserves the state's tax right." [158 Misc. 481, 286 N.Y.S. 142.]

The opinion notes that the executor has paid the tax out of the estate funds, and concludes that "he has by operation of the statute a right of subrogation to the position of the sovereign whose claim he has paid, and consequently he has in this instance the right to enforce against the insurance companies the same claims which the sovereign might have enforced had the tax not been paid." The decree specifically directed the insurance companies to deduct the amount of taxes required to be paid to the executor "out of *corpus* of the proceeds of said policies," and further directed the beneficiaries to return to the companies their evidence of rights under the policies for endorsement or for cancellation and reissue, "readjusted so as to deduct from the *corpus* of the benefits accruing to said respective beneficiaries under said certificates and said policies the amounts shown in said accounts and in this decree as Federal and New York estate taxes apportioned against the respective interests of those beneficiaries and paid by the company to the Executor, such deduction to be made from the funds representing the proceeds of said policies in each case."

In the Appellate Division the reasoning of the Surrogate was not sustained; the basis of the decision by the upper court was that "upon the death of the insured there is a transfer to the insurance company of property, the proceeds of the policy, and, while this transfer may be simply a matter of bookkeeping involving no segregation of specific funds, there is a sufficient change to justify the application of the [statute]." [149 App.Div. 542, 293 N.Y.S. 131.] The Court concluded that the insurance company was in possession of the property transmitted at death, and therefore was within the statute. The dissenting opinion argued that the insurance company was not, in the words of the statute, either in possession of estate property or a person interested in the estate. The point was urged that the result of requiring payment of the tax by the company was to accelerate its contractual obligations, and that such result was unconstitutional. This contention was expressly denied in the majority opinion without any reason given. This was also the basis for the application for certiorari to the Federal Supreme Court.

In the *Scott* case, as above noted, the New York courts construed the New York statute, which allocated the payment of the Federal tax on insurance policies to those "in possession" or those "interested" in the estate. We have no such statute in New Jersey, and in the absence of legislation this Court, under the circumstances of the case sub judice, it seems to me, is without authority to make an apportionment, and in addition to this, we are not here dealing with the questions raised in the *Scott* case under the New York statute. The controlling statute is that contained in §826(c) [1939 Code], as heretofore quoted, which provides that the executor may seek reimbursement from "beneficiaries."

That the insurance companies are not beneficiaries as mentioned in §826(c)

seems obvious and this finding is well supported by the opinion in *John Hancock Mutual Life Insurance Co.* v. *Helvering, supra*, as well as the reasoning in the dissenting opinion in the *Scott* case. In the *Hancock* case the Court carefully reviewed the various sections of the Federal statutes respecting the collection of Federal estate tax and came to the conclusion that under §827(b) [§6324(a)(2), 1954 Code], the insurance company was neither a beneficiary or transferee and that it was not liable to the payment of the Federal inheritance tax.*. . .

The death of Mr. Dannenbaum changed the relationship of insured and insurer as it theretofore existed between the insurance companies and decedent. On the death of Mr. Dannenbaum the insurance companies became liable to the payment of the monies as provided in the aforesaid settlement agreements in the amounts and at the times also therein specified. The recipients of these payments became the beneficiaries of these monies which the insurance companies had contracted to pay and the insurance companies were in no wise benefited by the proceeds of the policies on the death of Mr. Dannenbaum. Their assets were in no wise augmented at the time of his death. They became liable to pay out of their general assets that which they had contracted with decedent to pay. Under the Federal statutes, therefore, the recipients of these payments became the beneficiaries of the funds stipulated to be paid.

There is no New Jersey statute permitting the recovery by the executors from the insurance companies of any portion of the Federal estate tax paid by the executors, and in the absence thereof, no jurisdiction in this Court to decree reimbursement by the insurance companies.

My conclusion is that complainant is not entitled to a decree requiring the defendant insurance companies or any of them to reimburse complainant for the amount paid by her in satisfaction of either Federal estate tax or New Jersey estate tax.

Note

As the Court indicates, in New York an insurance company is regarded as "in possession of property immediately payable at the time of apportionment which is liable" for a portion of the tax. See Note, 30 *Ind. L. J.* 217, 230–2 (1955). What if the insurer has paid the proceeds to the beneficiary and he has dissipated the funds? *In re Zahn's Estate,* 300 N.Y. 1, 87 N.E.2d 558 (1949).

IN RE BLUMENTHAL'S ESTATE †

New York Surrogate's Court, 1943
182 Misc. 137, 46 N.Y.S.2d 688

FOLEY, Surrogate.

In this application for the construction of the will and for instructions as to the method of charging the Federal and State estate taxes, by my prior decision

* *Supra*, p. 1244. [Ed.]

† Affirmed by Appellate Division, 267 App. Div. 949, 47 N.Y S.2d 652 (1944), and by Court of Appeals, 293 N.Y. 707, 56 N.E.2d 588 (1944).

it was determined that all of the estate taxes must be prorated equitably against the testamentary beneficiaries other than the charities and against the donees by inter vivos transfers under the provisions of Section 124 of the Decedent Estate Law. *Matter of Blumenthal's Estate*, 180 Misc. 895, 42 N.Y.S.2d 898.

In the petition in the proceeding six different questions were originally presented for determination. The first and second were disposed of by my decision referred to above. Four other questions remain for disposition.

Upon the third question counsel for the widow attempt to reargue my prior determination decreeing allocation. The distribution directed by the testator in the residuary clause provided for an aggregate of 26 per cent to be given the charitable legatees and 74 per cent to non-charitable beneficiaries.

The widow and others who join in her contentions now seek to have all of the taxes paid as a primary deduction from the entire residue. By that method the charitable legatees would suffer a diminishment of their true interests under the will. These contentions are therefore overruled. The terms of Section 124 provide that in making the proration, "allowances shall be made for any exemptions granted by the act imposing the tax and for any deductions allowed by such act for the purpose of arriving at the value of the net estate."

It is immaterial whether the charitable bequests constitute an exemption or deduction although the latter term would seem to be more accurate in describing charitable benefits in both the Federal and State statutes. Section 249-s Tax Law, Int. Rev. Code, §812 [§2055, 1955 Code].

In the computation of the distribution of the tax, the interest of each person, whether pecuniary legatee, specific legatee or residuary legatee, and whether charitable or non-charitable, must be fixed in money under the terms of the will or under a non-testamentary transfer. Outright gifts or trusts for exclusive charitable purposes must be excluded since they were deducted in the ascertainment of the net estate upon which the taxes were computed and fixed. Only by this method may an equitable proration be effectuated as to the non-charitable beneficiaries and charities protected under the legislative plan.

I accordingly hold upon the third question that the estate taxes may not be deducted from the entire residue and further hold that the percentages of such entire residue must first be computed and the taxes apportioned against only the non-charitable beneficiaries. *Matter of Starr's Estate*, 157 Misc. 103, 282 N.Y.S. 957, *Matter of Dettmer's Will*, 179 Misc. 844, 40 N.Y.S.2d 99. My decision in *Matter of Weinstein*, March 16th, 1940, is in no way applicable to the facts and the terms of the will in the present proceeding. Necessarily the Surrogate is dealing with the taxes on the residuary estate. All other beneficiaries, whether testamentary or non-testamentary, must necessarily be brought into the allocation.

As to the fourth question the Surrogate holds, pursuant to the terms of Section 124, that the estate taxes on the legal life estate in certain tangible property given by the testator to his widow under article twenty-fifth of the will must be charged against the corpus of such tangible personal property. It is immaterial that the remainderman is a charity. The terms of Section 124 which direct that the proportional share of the taxes shall be charged out of the principal of the fund or property are mandatory. *Matter of Starr's Estate, supra; Matter of Dettmer's Will, supra.* The amount thereof may be paid to the executors in

money in reimbursement of the executors or by arrangement of the parties sufficient of the personal property may be sold and the proceeds applied to the amount of such taxes.

Upon the fifth question the Surrogate holds that the taxes on the annuities must be amortized out of the periodic amounts due the respective annuitants. The explanatory note which was before the Legislature at the time of the enactment of Section 124 did not confine the amortization of the tax to a restricted class of annuities or distinguish between the older form of the common law annuity or the modern form of such a benefit. The term "annuity" was significantly used by Mr. Blumenthal, the testator, in his will.

In the case of a benefit payable by way of income to the cestui of a trust, or an advantage derived by a legal life tenant, the terms of Section 124 exempt either of such beneficiaries from the direct charge for the proportional part of the taxes. The entire burden is placed by the terms of Section 124 upon the principal of the fund. On the other hand as to an annuity, since the gift was outright in form, although postponed over a series of years, it was made subject to a direct charge for the proportional part of the taxes. This rule, which had been applied previous to the enactment of the section in *Matter of Tracy*, 179 N.Y. 501, 72 N.E. 519, was expressly referred to in the explanatory note to the legislative measure. Similar interpretation has been given to the section in its relation to annuities by decisions subsequent to its effective date. (*Matter of Starr's Estate, supra; Matter of Matthews' Estate*, 164 Misc. 578, 300 N.Y S. 461, reversed upon other grounds, 255 App. Div. 80, 5 N.Y.S 2d 707, and 279 N.Y. 732, 18 N.E.2d 683), and by my dictum in *Matter of Brown*, March 13th, 1943. The taxes are therefore directed to be paid out of the funds set aside for the payment of annuities and amortized out of the respective annuities

The sixth question involves a situation which has arisen by the possibility of the inclusion within the net estate by the taxing authorities of certain gifts inter vivos upon the theory that such transfers were made in contemplation of death. Mr Blumenthal paid certain gift taxes on these transfers. It is claimed by the donees that the gift tax credits should be apportioned solely to them. In opposition to this claim other beneficiaries assert that such credits should be deducted from the total amount of the Federal estate tax and thereby apportioned to all of the persons sharing by any form of transfer. The Surrogate sustains the latter claim. These inter vivos transfers may be subjected to inclusion within the gross estate if they are hereafter found by the taxing authorities to have been made in contemplation of death. In that event the amount of the taxable estate will be increased and the burden of the additional share of taxes at higher rates will be cast upon persons who derive no benefit from such inter vivos transfers. In the consideration of questions under Section 124, the Courts have consistently followed the determination of the taxing authorities. *Matter of Mayer's Estate*, 174 Misc. 917, 22 N.Y S.2d 468, *Matter of Kaufman's Estate*, 170 Misc. 436, 10 N.Y.S.2d 616; *Matter of Ryle's Estate*, 170 Misc. 450, 10 N.Y.S.2d 597. Where a tax has been assessed by them against an inter vivos transfer which has been decided to have been made in contemplation of death, the actual situation is considered and perversion of the true nature of the transaction may not be resorted to. The Federal Government has treated the gift tax here as a payment made by the

donor on account of the general liability of his estate for all inheritance taxes. Under these circumstances equity requires that the credits should redound to the advantage of the entire group of parties charged with the burden of the tax and not confined to the donees only.

An analysis of the decision, *Irving Trust Co.* v. *Hitt,* July 25th, 1940, claimed to be applicable in favor of the inter vivos donees, shows that an entirely different state of facts were involved there and an equitable apportionment was applied in the allocation of the taxes in favor of those who had received no benefits and proportionally against those who did receive them.

Submit decree on notice construing the will and directing the apportionment of the taxes in accordance with this and the prior decision of the Surrogate.

Note

How should the marital deduction allowed by §2056 be allocated? Compare *In re Peters,* 204 Misc. 333, 88 N Y S 2d (Surr. Ct. 1940), *aff'd,* 275 App. Div. 950, 89 N.Y.S.2d 651(2d Dep't) *with Weinberg* v. *Safe Deposit and Trust Co.,* 198 Md. 539, 85 A.2d 50(1951). How should the deductions allowed by §§2053–5 and the credit of §2013 be allocated?

See Locke, "Administrative Difficulties in the Proration of the Federal Estate Tax," 21 *Conn. B.J.* 168 (1947), Note, "The Apportionment of the Federal Estate Tax in Pennsylvania," 54 *Dick. L. Rev.* 432 (1950), Note, 30 *Ind. L. J.* 217, 230–4 (1955); Reidy, "Apportionment of Estate Taxes: Application of State Statutes," 88 *Trusts and Estates* 623, 628 (1949).

IN RE MILLS' WILL *

App. Div., N.Y. Supreme Court, 1947
272 App. Div. 229, 70 N.Y.S.2d 746

DORE, Justice.

These appeals present two issues.

1. Did the testator's will contain a direction against apportionment of death taxes pursuant to Decedent's Estate Law, §124?

2. Were counsel fees in this accounting proceeding payable out of the estate to attorneys for the trustees of inter vivos trusts under Surrogate's Court Act, §278?

The testator, Ogden Livingston Mills, died October 11, 1937, leaving a net testamentary estate of over $7,900,000. Having no issue, he gave the bulk of his estate in a residuary clause establishing a trust for his wife for life with remainders in equal trusts for his stepchildren and a former ward.

During his life the testator had established two trusts one in 1932, which at death had a value of over $515,000; the other in 1935 having a value at his death of about $350,000. These two trusts provided that the income should be paid to the donor's wife for her life and on her death remainders were given to the donor's stepson or his issue. In 1930 the testator had also made a gift to a third

* Affirmed, 297 N.Y. 1012, 80 N.E.2d 535 (1948).

trust of securities of the value at his death of $12,625; as trustee of this trust the testator during his life had the right at any time to terminate the trust and pay over the principal to the life beneficiary, the testator's former ward, George Winthrop Sands.

A portion of the corpus of the three trusts was included by the taxing authorities in the testator's taxable estate and the total death taxes on such portion amounted to over $132,000. The primary issue is whether such taxes should be paid out of testator's residuary estate or apportioned against the inter vivos trusts.

The learned Surrogate held that the trusts must bear their share of the tax burden in accordance with the provisions of Decedent Estate Law, §124, on the ground that there was no clear direction in the will against apportionment. He also denied an application by the attorneys for the trustees of the 1929 and 1932 trusts for allowances for their services in the proceeding and from such denial the trustees of those two trusts appeal. From that part of the decree which charged and apportioned the taxes against the trusts, the trustees of the three inter vivos trusts and a special guardian for infants, issue of testator's stepson, and also for such stepson as a party in military service, appeal contending that under Article Eleventh of the will all of the death duties in question should be paid out of the residuary estate without apportionment.

1. Apportionment of Taxes under Decedent Estate Laws, §124

Article Eleventh of the will provides: "Eleventh: I direct that all estate, inheritance, transfer and succession taxes imposed upon my estate or any part thereof, or the transfer thereof or any right of succession thereto, be paid out of my general estate." The general estate here means the residuary estate.

Decedent Estate Law, §124, so far as relevant provides that death taxes with respect to any property required to be included in the gross estate of the decedent "except in a case where a testator otherwise directs in his will, . . . shall be equitably pro rated among the persons interested in the estate to whom such property is or may be transferred or to whom any benefit accrues."

Construing this section, the Surrogate held that the direction against apportionment must be "a clear direction"; that, lacking clarity in the language of the will, the statute makes the rule, and apportionment should be directed, that at best the language of Article Eleventh is obscure and, as no clear direction against apportionment was made, apportionment of the taxes against the trustees should be directed.

Decedent Estate Law, §124, is a statutory mandate to apportion unless the testator "otherwise directs in his will." Article Eleventh is indeed broadly inclusive as to the type of taxes involved but is expressly limited and qualified as to the kind of property referred to. The broad language relating to taxes is limited by the qualifying phrase "imposed upon my estate." The narrow issue is whether in referring to "my estate" in that clause of the will, the testator intended his true or testamentary estate or the artificial taxable estate. Elsewhere throughout the will testator used the words "my estate" a great number of times and in every instance he referred only to his true or testamentary estate.

The legislative history of the statute as well as its language indicates that apportionment is the rule to which exception is allowed only if there be clear direction

to the contrary. The purpose of the statute is equitable and reasonable to provide that those who receive benefits should normally bear their proportionate burden of the taxes and not impose them without clear direction on residuary legatees who are often, the testator's wife or children the natural objects of his bounty. We agree with the Surrogate to the extent of holding that the clause in question is at least ambiguous and in the absence of a clear and unambiguous direction against apportionment, the mandate of the statute must prevail.

The subsequent language in clause Eleventh "or any part thereof," or "any transfer thereof" *etc.* necessarily means part "of my estate" and transfer "of my estate." These phrases carry the same limitation as to the kind of property referred to. As the numerous briefs indicate, it is at least arguable that testator was referring to his true or testamentary estate, not to an artificial tax estate which was deemed to include, solely by the mandate of taxing authorities, property the testator thought he had fully parted with long before his death.

The briefs cite and analyze many cases involving tax provisions in other wills, few of such cases have received appellate consideration, it would unduly enlarge this opinion to discuss them seriatim; and in any event authorities are of little help as the intention expressed in a will depends "upon the varying language used and the varying conditions surrounding the testator." *Furniss* v. *Cruikshank*, 230 N.Y. 495, 505, 130 N.E. 625, 628.

The decision of this court in *Matter of Halle's Will*, 270 App.Div. 619, 623, 61 N.Y S.2d 694, 697, heavily relied on by appellants, is not here applicable. As we there said. "The matter of intention is to be determined in each case upon a consideration of the language used in the light of the surrounding circumstances." In that case the decedent directed without any qualifying phrase or words that " 'all inheritance, estate, transfer and succession taxes be paid out of my residuary estate.' " There the direction was unrestricted, there was no limitation such as that found in the will before us, *viz*, that the taxes so to be paid were only those imposed upon "my estate," a phrase that had the uniform meaning throughout the will of the true or testamentary estate.

Keeping in mind the mandate of Section 124 and the at least ambiguous language in Article Eleventh, we think the entire will shows no clear intention to absolve the *inter vivos* trusts from apportionment of taxes. Especially is this so in the light of the law as it stood in 1935 when the will was drawn. The decedent had been a member of the New York bar and served from 1927 to 1932 as Under-Secretary and from 1932 to 1933 as Secretary of the United States Treasury. In this capacity it was one of his duties to approve all federal tax regulations. It was not until *Helvering* v. *Hallock*, 309 U.S. 106, decided in 1940, and *Matter of Pratt's Estate*, 262 App.Div. 240, 28 N.Y.S.2d 997, decided in 1941, that the inclusion of principal of an *inter vivos* trust in a decedent's artificial or taxable estate was finally settled. The testator died in 1937. The will should be read in the light of the law applicable when it was drawn and on the date of death. *Matter of Duryea's Estate*, 277 N.Y. 310, 14 N.E 2d 369.

Accordingly, we conclude that the taxes on the three trusts were properly apportioned as proposed by the accounting parties in the accounting approved by the Surrogate. On this, the main issue on appeal, the decree, so far as appealed from, should be affirmed. . . .

Note

Does the Court imply that the phraseology of *Matter of Halle's Will* would have barred apportionment? Virtually identical language was held to be insufficient in *McLaughlin* v. *Green*, 136 Conn. 138, 69 A.2d 289 (1949). In the latter case the Court approved as air-tight a more detailed statement against apportionment. Decisions with respect to a variety of clauses are collected in the articles by Karch and Fleming, cited *supra*, p. 1247.

If a penalty is imposed on the estate, must it be apportioned on the same basis as the tax itself? See *In re Harbord's Will*, 95 N.Y.S.2d 407 (Surr. Ct. 1950).

Section B. The Gift Tax

Note

A gift tax return (on Form 709) must be filed by any person who makes a gift (or several gifts in one calendar year) to any one donee of a value of more than $3,000, or a gift of a future interest regardless of its value. §6019(a). The return must be filed even if the gift is not taxable because the donor has not exhausted his $30,000 exemption. Any gift that requires a return by the donor also requires an information return (Form 710) by the donee or, if the transfer is in trust, by either the beneficiary or the trustee. Regs. 108, Sec. 86.21.

See Clark, "Federal Tax Liens and Their Enforcement," 33 *Va. L. Rev.* 13 (1947); Peters and Maxey, "The Gift Tax Lien and the Examination of Abstracts," 5 *Miami L. Q.* 64 (1950)

BAUR v. COMMISSIONER

U.S. Court of Appeals, Third Circuit, 1944
145 F.2d 338

Before Bratton and Jones, Circuit Judges, and Kirkpatrick, District Judge.

Jones, Circuit Judge.

The questions raised by the pending petition for review are (1) whether the donee of a gift of untaxable amount is personally liable, to the extent of the value of the gift, for an unpaid tax on a gift to another donee made by the same donor in the same calendar year and (2) whether such liability, if it exists, may be enforced against the donee, as a transferee, after the statute of limitations has run against the donor's liability, in the absence of proof that the donor was insolvent or that the gratuitous transfers made the donor insolvent.

The questions relate to the Revenue Act of 1932, 47 Stat. 169, c. 209. The facts, under which they arise, were stipulated and, so far as they are presently material, are as follows.

In 1937 Emma M. Baur made three gifts, in securities, of a value of $5,000 each. One gift was to her daughter, the petitioner, personally, the second to another daughter personally and the third to the petitioner as trustee under a deed of trust, executed in 1935, for the benefit of a minor daughter. In the donor's gift tax return for the year in question she reported the three gifts, claimed a $5,000

exclusion * with respect to each and showed no net gifts subject to tax. The period within which a tax could be assessed against the donor on account of her gifts in 1937 expired by virtue of the statute of limitations on March 12, 1941, without any such liability on the part of the donor having been determined. However, within a year thereafter, *viz.*, on March 12, 1942, the Commissioner sent the petitioner a notice by registered mail informing her of a deficiency in the donor's gift tax for the year 1937 because of the disallowance of the $5,000 exclusion for the gift in trust which the Commissioner held to be a gift of a future interest. . . . The petitioner now concedes that the Commissioner's determination of the taxability of the gift in trust was correct. The Commissioner's notice was addressed to the petitioner as donee and transferee of Emma M. Baur, donor, and determined a deficiency against the petitioner for the later ascertained gift tax due by the donor for the year 1937 which remained unpaid. On the taxpayer's petition for a redetermination of the deficiency the Tax Court sustained the Commissioner both as to the petitioner's liability for the tax and the manner of enforcing it.

In presently material part, Sec. 510 of the statute [§6324(b), 1954 Code] provides that,—

> The tax imposed by this title shall be a lien upon *all* gifts made during the calendar year, for ten years from the time the gifts are made. If the tax is not paid when due, the donee of *any* gift shall be personally liable for such tax to the extent of the value of such gift. . . . (Emphasis supplied.)

The words of the provision above quoted are so plain as not to leave any room for doubt that it was the congressional intent, thereby, to render a donee personally liable (to the extent of the value of his gift) for the gift tax due by the donor regardless of the fact that the gift to the particular donee did not contribute to the imposition of any tax. In short, it is the evident legislative intent that property passing from an owner to a voluntary recipient by way of donation shall be liable for any taxes due by the donor on account of his gratuitous distributions within the calendar year. We can see no escape from this conclusion. Patently, the tax imposed upon the donor by the Act is made a lien upon *all* gifts (not just the gifts subject to tax) made during a calendar year; and, if the tax so imposed is not paid when due, the donee of *any* gift (again not just gifts subject to tax) is made personally liable for the tax due by the donor to the extent of the value of such donee's gift. The latter is the only limitation in amount which the statute places upon a donee's liability for gift tax due by his donor. . . .

Even if resort be had to the reports of the appropriate committees of Congress with respect to the gift tax provisions of the Revenue Act of 1932, as the petitioner urges in support of her argument, we fail to see wherein the legislative history supports the contention that it is only donees of gifts which contribute to the donor's liability for tax who are made liable for the tax. The reasons given to the Houses of Congress by their respective Committees in justification of the exclusion relate to the relief of the donor from tax upon certain gifts and have nothing to do with the several liabilities of the donor and his donees for gift taxes which the

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* As seen *supra*, p. 908, the exclusion was later reduced by Congress to $4,000 and then to $3,000. [Ed.]

donor does owe.[1] If our conclusion as to the petitioner's liability for the tax in the present circumstances leads to rendering the donee of a gift of relatively small value liable, to the extent of the value of his gift, for gift taxes due by the donor, the answer is that any change in that situation is a matter for Congress and not for the courts.

The petitioner also points out that, as a donor is under no duty, see Sec. 507(a) of the Act, to report a gift of $5,000 or less, ordinarily donees of such gifts will not be ascertainable for imposition of the liability incident to the gift tax due by the donor. At most, that argument poses an administrative difficulty which furnishes no justification for ignoring the plainly expressed legislative intent with respect to a donee's liability for tax. In the present instance, both the donor and the petitioner reported the gift, so that the difficulty, which the petitioner apprehends, is not present here in any event. The question of the petitioner's liability for the tax should therefore not be confounded by it.

As to the method of collecting the tax due by a donee, Sec. 526(a) of the Revenue Act of 1932 [§6901(a)(1)(iii), 1954 Code], which treats with transferred assets, provides that,—

> The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in the tax imposed by this title . . .
>
> (1) Transferees. The liability, at law or in equity, of a transferee of property of a donor, in respect of the tax . . . imposed by this title. . . .

Sec. 526(f) [§6901(h), 1954 Code] defines the term "transferee" as including a "donee, heir, legatee, devisee, and distributee."

Sec. 517(a) [§6501(a), 1954 Code] prescribes the period within which the taxes imposed by the Act may be assessed as being three years after the filing of the return. This limitation obviously has to do with the donor's liability for the tax as it is the filing of his return which begins the running of the three year period of limitations. Moreover, Sec. 526(b)(1) [§6901(c), 1954 Code] fixes the period of limitation against assessment of a donee's liability, as a transferee, at one year from the expiration of the period of limitation for assessment against the donor.

While the liability of a transferee made subject to the method of collection prescribed in Sec. 526(a) may be either a liability at law or in equity, it is immaterial what the liability may be in equity when the liability sought to be enforced is a liability at law. In the instant case, the liability which the Commissioner has imposed upon the petitioner is manifestly a legal liability. It arises by virtue of the positive statutory imposition of Sec. 510. See *Fletcher Trust Co.*

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[1] See report of House Committee on Ways and Means No. 708, 72nd Cong., 1st Sess., pp. 29–30 (1939–1 Cum. Bull. (Part 2) 457, 478), and report of Senate Committee on Finance No. 665, 72nd Cong., 1st Sess., p. 41 (1939–1 Cum. Bull. (Part 2) 496, 525–526). Both Committee reports, in treating with the exclusion (which was raised from $3,000 to $5,000 in the Senate), said that "Such exemption, on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other hand, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."

v. *Commissioner*, 7 Cir., 141 F 2d 36, 40. Such being the case, it is wholly immaterial to the enforcement of the legal liability whether the transfers rendered the donor insolvent or whether he remained solvent during the period of his enforceable liability for the tax. That such matters would be of bearing if the liability sought to be enforced was in equity, is wholly without significance to the enforcement of the donee's liability at law. See *Moore* v. *Commissioner*, 1 T.C. 14. The cases cited by the petitioner where the liability sought to be imposed was in equity are obviously, therefore, not in point. The Commissioner's deficiency notice to the donee having been mailed within a year after the expiration of the period of limitations applicable to assessment of the donor, it follows that the notice to the donee was timely. *Fletcher Trust Co.* v. *Commissioner* and *Moore* v. *Commissioner, supra.*

The decision of the Tax Court is affirmed.

Note

See also *Moore* v. *Commissioner*, 146 F.2d 445 (2d Cir. 1945).

If the donee's interest in the transferred property is defeasible (for example, by the donee's predeceasing the donor or by the exercise of a power to alter or amend vested in a third party), may transferee liability be imposed upon the donee? See *Estate of Sanford* v. *Commissioner, supra,* at pp. 1076–7.

TABLE OF CASES

Italic capitals denote cases that are reprinted; cases cited in the editor's *Notes* are in roman.

INDEX